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REVIEW OF THE CIVIL PENALTY PROVISIONS CONTAINED IN THE INTERNAL REVENUE CODE

HEARINGS

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT

OF THE

COMMITTEE ON WAYS AND MEANS

HOUSE OF REPRESENTATIVES

ONE HUNDREDTH CONGRESS

SECOND SESSION

MARCH 31; AND JULY 28, 1988

Serial 100-75

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[1] Died June 21, 1988.

[2] Elected to committee July 7, 1988.

[3] Resigned subcommittee July 15, 1988.

[4] Appointed to subcommittee July 15, 1988.

CONTENTS

Page

Press releases announcing the hearings ... 2

WITNESSES

Internal Revenue Service, Hon. Lawrence B. Gibbs, Jr., Commissioner of Internal Revenue, Charles Brennan, Deputy Commissioner (Operations), and Richard Stark, Assistant to the Commissioner ... 8

U.S. Department of the Treasury, Dennis E. Ross, Deputy Assistant Secretary (Tax Policy) ... 16

U.S. Tax Court, Hon. Samuel B. Sterrett, Chief Judge ... 27

U.S. General Accounting Office, Johnny C. Finch, Deputy Director, General Government Division, and Lynda Willis, Group Director, Tax Policy and Tax Administration Audit Group ... 51

U.S. Small Business Administration, Frank S. Swain, Chief Counsel for Advocacy ... 295

Alexander, Donald C. (former Commissioner of Internal Revenue), Cadwalader, Wickersham & Taft, Washington, D.C. ... 166

Allen, Jonathan W., Wachovia Corp., and American Bankers Association ... 510

American Bankers Association, Jonathan W. Allen ... 510

American Bar Association, Section of Taxation:

  - Charles W. Hall ... 80
  - Michael I. Saltzman ... 356
  - Charles J. Muller ... 422
  - James E. Merritt ... 447
  - American Bar Foundation, Kent W. Smith ... 465

American Institute of Certified Public Accountants, Donald H. Skadden presenting statement of Herbert J. Lerner ... 117

American Society of Pension Actuaries, Chester J. Salkind ... 582

Association of Private Pension and Welfare Plans, Gerald L. Uslander ... 573

Burton, David R., U.S. Chamber of Commerce ... 558

Caplin, Mortimer (former Commissioner of Internal Revenue), Caplin & Drysdale, Washington, D.C. ... 177

Cohen, Sheldon S. (former Commissioner of Internal Revenue), Morgan, Lewis & Bockius, Washington, D.C. ... 171

East River Savings Bank, Nelson L. Stephenson ... 533

Egger, Roscoe L., Jr. (former Commissioner of Internal Revenue), Price Waterhouse, Washington, D.C. ... 151

Fischer, Hank, TCF Banking & Savings, and United States League of Savings Institutions ... 518

Former Commissioners of Internal Revenue:

  - Roscoe L. Egger, Jr ... 151
  - Jerome Kurtz ... 161
  - Donald C. Alexander ... 166
  - Sheldon S. Cohen ... 171
  - Mortimer Caplin ... 177

Gideon, Kenneth W., Fried, Frank, Harris, Shriver & Jacobson, Washington, D.C. ... 222

Golato, Al James, H&R Block, Inc ... 126

Goldberg, Fred T., Jr., Skadden, Arps, Slate, Meagher & Flom, Washington, D.C. ... 189

H&R Block, Inc., Al James Golato ... 126

Hall, Charles W., American Bar Association, Section of Taxation ... 80

Page
Hopkins, Bruce R., Baker & Hostetler, Washington, D.C 227
Huard, Paul R., National Association of Manufacturers 545
Kurtz, Jerome (former Commissioner of Internal Revenue), Paul, Weiss, Rifkind, Wharton & Garrison, Washington, D.C 161
Lerner, Herbert J. (See American Institute of Certified Public Accountants.)
MCI Communications Corp., Charles W. Rau 89
Merritt, James E., American Bar Association, Section of Taxation 447
Mirman, Louis, National Society of Public Accountants 111
Moss, Howard Christopher, Washington, D.C 565
Muller, Charles J., American Bar Association, Section of Taxation 422
National Association of Enrolled Agents, David J. Silverman 121
National Association of Manufacturers, Paul R. Huard 545
National Council of Savings Institutions, Nelson L. Stephenson 533
National Federation of Independent Business, Abraham Schneier 550
National Society of Public Accountants, Louis Mirman 111
National Society of Tax Professionals, Douglas Walker 528
National Treasury Employees Union, Robert M. Tobias 66
Portney, Gerald G., Peat Marwick Main & Co., Washington, D.C 478
Rau, Charles W., MCI Communications Corp., and Tax Executives Institute 89
Salkind, Chester J., American Society of Pension Actuaries 582
Saltzman, Michael I., American Bar Association, Section of Taxation, ... 356
Schneier, Abraham, National Federation of Independent Business 550
Scrobola, John W., Merrill Lynch, Fenner & Smith, and Securities Industry Association 490
Securities Industry Association, John W. Scrobola 490
Silverman, David J., National Association of Enrolled Agents 121
Skadden, Donald H., presenting statement of Herbert J. Lerner, American Institute of Certified Public Accountants 117
Smith, Kent W., American Bar Foundation 465
Stephenson, Nelson L., East River Savings Bank, and National Council of Savings Institutions 533
Tax Executives Institute, Inc., Charles W. Rau 89
TCF Banking & Savings, Hank Fischer 518
Tobias, Robert M., National Treasury Employees Union 66
U.S. Chamber of Commerce, David R. Burton 558
United States League of Savings Institutions, Hank Fischer 518
Uslander, Gerald L., William M. Mercer Meidinger Hansen, Inc., and Association of Private Pension and Welfare Plans 573
Wachovia Corp., Jonathan W. Allen 510
Walker, Douglas, National Society of Tax Professionals 528
William M. Mercer Meidinger Hansen, Inc., Gerald L. Uslander 573

APPENDIX

A. Questions submitted to the Internal Revenue Service 241
B. U.S. Department of the Treasury, Internal Revenue Service, response to questions 1 and 2 244
C. U.S. Department of the Treasury, Internal Revenue Service, response to question 3 278

SUBMISSIONS FOR THE RECORD

U.S. Department of the Treasury, Internal Revenue Service, Michael J. Murphy, Acting Commissioner of Internal Revenue, letter enclosing comments on SBA report 592

A. Avery & Co., Anson Avery, letter 604
Coopers & Lybrand, Pamela J. Pecarich, letter 606
Houlihan, John B. and Craig M. Horn, Fresno, California, joint letter 609
Lakehead Pipe Line Co., Inc., Benny J. Phillips, letter and attachment 611
Morrell, John H., Jr., Jupiter, Florida, letter 619
Moss Adams, Paul Tholfsen, statement 620
National Campaign for a Peace Tax Fund, et al., Peter Goldberger, joint statement 622

REVIEW OF THE CIVIL PENALTY PROVISIONS CONTAINED IN THE INTERNAL REVENUE CODE

THURSDAY, MARCH 31, 1988

House of Representatives,
Committee on Ways and Means,
Subcommittee on Oversight,
Washington, DC.

The subcommittee met, pursuant to call, at 8:30 a.m., in room 2212, Rayburn House Office Building, Hon. J.J. Pickle (chairman of the subcommittee) presiding.

[The press releases announcing the hearings follow:]

FOR IMMEDIATE RELEASE
MONDAY, MARCH 7, 1988

PRESS RELEASE #14
SUBCOMMITTEE ON OVERSIGHT
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
1105 LONGWORTH HOUSE OFFICE BLDG.
WASHINGTON, D. C. 20515
TELEPHONE: (202) 225-5522

THE HONORABLE J. J. PICKLE (D., TEXAS), CHAIRMAN SUBCOMMITTEE ON OVERSIGHT, COMMITTEE ON WAYS AND MEANS U.S. HOUSE OF REPRESENTATIVES ANNOUNCES HEARINGS TO REVIEW THE CIVIL PENALTY PROVISIONS CONTAINED IN THE INTERNAL REVENUE CODE

The Honorable J. J. Pickle (D., Texas), Chairman of the Subcommittee on Oversight, Committee on Ways and Means, U.S. House of Representatives, announced today that the Subcommittee will conduct a series of hearings to review the structure, fairness, effectiveness, and application of the civil penalty provisions contained in the Internal Revenue Code. This initial hearing will be the first in a series of hearings conducted throughout the second session of the 100th Congress in which the Subcommittee will comprehensively examine present law civil penalties. The Subcommittee plans to provide a report with recommendations to the full Committee upon completion of its review.

The first hearing is scheduled for Thursday, March 31, 1988, beginning at 9:00 a.m., in the main Committee hearing room, 1100 Longworth House Office Building. The Subcommittee will receive testimony from invited witnesses including representatives of the Department of the Treasury and the Internal Revenue Service (IRS). Additional hearings will be scheduled in the future at which time public witnesses will be given an opportunity to testify. These hearings will be announced in subsequent press releases.

The Subcommittee hearings will focus on approximately 150 penalty provisions contained in the Internal Revenue Code. The current tax penalty system is designed to improve taxpayer compliance and to deter specific forms of behavior by penalizing those who do not conform to the requirements of the laws relating to Federal taxes. These penalties cover a wide range of activities and are of concern to varying segments of the population. Over the years, numerous penalties have been added to the Code as part of various Revenue Acts. This piece-meal legislation, however, has resulted in a complex penalty system that is often difficult for the IRS to administer and for the taxpayer to comprehend.

The first hearing will focus on the existing penalty structure. With nearly 150 penalties in the Code, the IRS, taxpayers, tax practitioners, and information providers face substantial compliance and administrative burdens resulting from the complexities involved with implementation of these provisions. The Subcommittee will address the following issues:

1. What is, or should be, the purpose of the tax penalty system? What is the penalty structure designed to accomplish? What factors or framework of issues should the Subcommittee consider in evaluating the current penalty structure? What are the projections for the future if the current system remains the same?

2. How might the current penalty structure be reformed? Are existing civil penalties fair and equitable? Are the current penalties consistent, necessary, and understandable? Are existing penalties realistic in relation to the offenses to which they relate? Are they effective deterrents to noncompliance? What are the effects of the current level of penalties on taxpayer morale and compliance?

(over)

3. How is the IRS administering the current penalty provisions? Which penalties are frequently assessed and abated? What internal procedural changes has the IRS adopted to improve the administration of the penalty provisions? What efforts can be taken to make the penalty provisions more understandable to the taxpayer?

In announcing the first hearing, Chairman Pickle stated:

"Over the past decade, the number and scope of tax penalties and other sanctions have increased dramatically. As a result, the current penalty system has become entirely too complex. In order for penalties to be effective, they must be clear to the taxpayer and easy for the IRS to administer.

"The purpose of these hearings is to thoroughly review the penalty system and look for ways to improve and strengthen it. My goal is to develop a penalty framework that is fairer, simpler, and easier to administer. It is important to maintain the trust of honest taxpayers by ensuring that there are proper penalties for those who fail to comply with the tax laws."

DETAILS FOR SUBMISSION OF REQUESTS TO BE HEARD:

Individuals and organizations interested in presenting oral testimony before the Subcommittee at future hearings must submit their requests to be heard no later than Friday, April 8, 1988, by formal written request to Robert J. Leonard, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, Room 1102 Longworth House Office Building, Washington, D.C. 20515.

Requests should indicate the specific issues and points the witness wishes to address, in order to facilitate scheduling. It is urged that persons and organizations having a common position make every effort to designate one spokesperson to represent them in order for the Subcommittee to hear as many points of view as possible after the filing deadline. The Subcommittee staff will notify those scheduled to appear as soon as possible. Any questions concerning a scheduled appearance should be directed to the Subcommittee staff at (202) 225-5522.

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:

Persons submitting written comments for the printed record of the hearings should submit six (6) copies by the close of business, Friday, July 1, 1988, to Robert J. Leonard, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, Room 1102 Longworth House Office Building, Washington, D.C. 20515. The deadline for submission of written comments will be extended for thirty (30) days after the conclusion of the Subcommittee's series of hearings. Subsequent press releases will announce the final deadline for submission of written comments.

SEE FORMATTING REQUIREMENTS BELOW:

Each statement presented for printing to the Committee by a witness, any written statement or exhibit submitted for the printed record or any written comments in response to a request for written comments must conform to the guidelines listed below. Any statement or exhibit not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All statements and any accompanying exhibits for printing must be typed in single space on legal-size paper and may not exceed a total of 10 pages.
2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.
3. Statements must contain the name and capacity in which the witness will appear or, for written comments, the name and capacity of the person submitting the statement, as well as any clients or persons, or any organization for whom the witness appears or for whom the statement is submitted.
4. A supplemental sheet must accompany each statement listing the name, full address, a telephone number where the witness or the designated representative may be reached and a topical outline or summary of the comments and recommendations in the full statement. This supplemental sheet will not be included in the printed record.

The above restrictions and limitations apply only to material being submitted for printing. Statements and exhibits or supplementary material submitted solely for distribution to the Members, the press and public during the course of a public hearing, may be submitted in other forms.

** NOTICE -- CHANGE IN TIME **

FOR IMMEDIATE RELEASE
TUESDAY, MARCH 29, 1988

PRESS RELEASE #14-REVISED
SUBCOMMITTEE ON OVERSIGHT
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
1105 LONGWORTH HOUSE OFFICE BLDG.
WASHINGTON, D.C. 20515
TELEPHONE: (202) 225-5522

THE HONORABLE J. J. PICKLE (D., TEXAS), CHAIRMAN, SUBCOMMITTEE ON OVERSIGHT, COMMITTEE ON WAYS AND MEANS, U.S. HOUSE OF REPRESENTATIVES, ANNOUNCES A TIME CHANGE IN THE HEARING TO REVIEW CIVIL PENALTY PROVISIONS CONTAINED IN THE INTERNAL REVENUE CODE

The Honorable J. J. Pickle (D., Texas), Chairman of the Subcommittee on Oversight, Committee on Ways and Means, U.S. House of Representatives, announced today that the Subcommittee's hearing scheduled on Thursday, March 31, 1988, **will begin at 8:30 a.m.**, instead of the previously scheduled 9:00 a.m. The hearing will review the civil penalty provisions contained in the Internal Revenue Code.

Background information and an outline of the scope of the Subcommittee's review are contained in the Subcommittee on Oversight Press Release #14, dated March 7, 1988.

* * * * *
* * *

FOR IMMEDIATE RELEASE
FRIDAY, JULY 8, 1988

PRESS RELEASE #23
SUBCOMMITTEE ON OVERSIGHT
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
1105 LONGWORTH HOUSE OFFICE BLDG.
WASHINGTON, D.C. 20515
TELEPHONE: (202) 225-5522

THE HONORABLE J. J. PICKLE (D., TEXAS), CHAIRMAN, SUBCOMMITTEE ON OVERSIGHT, COMMITTEE ON WAYS AND MEANS, U. S. HOUSE OF REPRESENTATIVES, ANNOUNCES SECOND HEARING TO REVIEW THE CIVIL PENALTY PROVISIONS CONTAINED IN THE INTERNAL REVENUE CODE

The Honorable J. J. Pickle (D., Texas), Chairman of the Subcommittee on Oversight, Committee on Ways and Means, U.S. House of Representatives, announced today that the Subcommittee will hold its second hearing this year to review the civil penalty provisions contained in the Internal Revenue Code. The Subcommittee is currently conducting a comprehensive review of present-law civil penalties and plans to provide a report with recommendations to the full Committee early next year. The purpose and scope of the Subcommittee's review was outlined in Press Release #14, dated March 7, 1988.

The hearing has been scheduled for Thursday, July 28, 1988, beginning at 9:00 a.m., in the main Committee hearing room, 1100 Longworth House Office Building. The Subcommittee will receive testimony from invited witnesses on third-party information-reporting penalties, penalties applicable to employee plans, and penalties affecting businesses. In addition, the Subcommittee will receive the American Bar Association's set of recommendations concerning penalty reform along with comments from respected tax practitioners.

In announcing the hearing, Chairman Pickle made the following statement: "The first hearing identified a number of significant problems with the existing civil penalty structure. We heard complaints that penalties are too complex for the IRS to administer; too complex for the taxpayer to understand; too many; and, in some instances, too harsh. As we continue with our review of the penalty system, the Subcommittee will hear from various witnesses affected by the current system and from those who will provide us with concrete recommendations. I am hopeful that the result of our examination will be a fairer, more effective, and rational penalty system."

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:

Persons submitting written comments for the printed record of the hearing should submit six (6) copies by close of business, Friday, August 26, 1988, to Robert J. Leonard, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, Room 1102 Longworth House Office Building, Washington, D.C. 20515.

SEE FORMATING REQUIREMENTS:

Each statement presented for printing to the Committee by a witness, any written statement or exhibit submitted for the printed record or any written comments in response to a request for written comments must conform to the guidelines listed below. Any statement or exhibit not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. **All statements and any accompanying exhibits for printing must be typed in single space on legal-size paper and may not exceed a total of 10 pages.**
2. **Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.**
3. **Statements must contain the name and capacity in which the witness will appear or, for written comments, the name and capacity of the person submitting the statement, as well as any clients or persons, or any organization for whom the witness appears or for whom the statement is submitted.**
4. **A supplemental sheet must accompany each statement listing the name, full address, a telephone number where the witness or the designated representative may be reached and a topical outline or summary of the comments and recommendations in the full statement. This supplemental sheet will not be included in the printed record.**

The above restrictions and limitations apply only to material being submitted for printing. Statements and exhibits or supplementary material submitted solely for distribution to the Members, the press and public during the course of a public hearing, may be submitted in other forms.

Chairman **Pickle**. We will ask the subcommittee to please come to order and ask you guests to take your seats, if you will, please.

Today, the Subcommittee on Oversight begins its review of the structure, application, fairness, and effectiveness of the civil penalty provisions contained in the Internal Revenue Code. Our series of hearings on penalty reform will be the first time the Congress has taken a comprehensive look at our civil tax code penalty system, and analyzed what we have on the books. Our review is the natural outgrowth and necessary followup to the Tax Reform Act of 1986, as well as the accumulating complexities that have developed through the years with our tax code system.

I want to thank our distinguished witnesses for being with us on our maiden voyage to penalty reform. What you tell this subcommittee here today will chart our course over the next few months. I particularly want to thank the Internal Revenue Service Commissioner, the Honorable Lawrence B. Gibbs, for his initiative in this area.

I recognize that Mr. Gibbs has to leave to be on the other side of the Capitol within an hour. So we are going to proceed quickly.

Penalties have been a necessary component to our system of voluntary compliance since they were first enacted in the Revenue Act of 1913. Recent years, however, have witnessed an explosion in the number of penalties, the types of behavior penalties addressed, and the amount of penalty dollars assessed. The number of penalties in the Tax Code have more than doubled in the last decade as have the number of penalties assessed.

Further, for fiscal year 1978, the IRS assessed penalties in the amount of $1.3 billion. For 1987, 19 years later, penalty assessments have increased to $14.2 billion. I'll have to say that a jump from $1.3 to $14.2 billion in 9 years catches my attention.

The hodge-podge of nearly 150 penalties in the code today were added in a piecemeal fashion, oftentimes in direct response to a serious compliance problem. Taxpayers and tax practitioners are feeling frazzled. We hear complaints that penalties are too complex to administer, too complex to understand, too numerous, and too harsh.

We hear complaints that penalties overlap to the point that the amount ultimately imposed is grossly out of proportion to the offense committed. We hear complaints that the penalty system is unfair, and is not applied on a consistent, uniform, and rational basis. To the extent that all of this is really true, then the current penalty system may well deter, rather than enhance, voluntary compliance. Such a course must be redirected, and soon.

We want to be certain that the current tax penalty system will not cause further complexities or hesitations or frustration because we want to enhance the taxpayer's voluntary compliance system.

I want to say in a word of caution, we must not lose sight of the fact that current penalties are enacted for a purpose. We simply can't throw out all the penalties just because some say they may be too harsh or complex. That would ruin the system.

Penalties serve a very definite purpose. The question is, how can we adopt a system that would be more fair and less complex and more effective and wouldn't be quite as numerous? We wanted to start today by asking questions. We are going to have other hearings as we go along. We are going to ask your help because this group testifying today is coming here to give us good, wise information from experience. More perhaps, than any other group of practitioners in the country.

We have a problem. It is as difficult as any problem we face this year. How can we have a better system? We ought to strive to do it.

Mr. Schulze, do you have a statement?

Mr. SCHULZE. Thank you, Mr. Chairman. Yes, I do. I join you in opening today's hearing on civil tax penalties. There are about 150 penalty provisions in the tax law today. This is a significant increase over the early 1970's when there were, Mr. Chairman, about 60 penalty provisions.

The historical purpose for a tax penalty was to reinforce taxpayer compliance. The revenue generated by penalties was supposed to be an incidental byproduct, not the main attraction. However, the net revenue generated has grown from $1 to $10 billion in 10 years. It raises the question whether Congress and the administration departed from the traditional use of penalties to reinforce compliance to a penalty system designed to raise revenue. For example, we know from our hearings 2 weeks ago on the tax gap that the overall compliance rate has held steady in the low 80 percent range over the last 10 years.

Thus, the dramatic increase in the number of penalties and penalty revenue over the last 10 years do not appear to have had much effect on improving compliance. This raises serious policy questions. If a penalty is supposed to improve taxpayer compliance, then there should be some reasonable relationship between the penalty and taxpayers' conduct.

It is difficult to appreciate how a penalty which is imposed without regard to a taxpayer's state of mind can be expected to influence his conduct. Furthermore, the patchwork array of multiple penalties contribute to the atmosphere of complexity and frustration. There are no consistent rules for imposing and waiving penalties.

Various penalties have different criteria for their application and abatement. One practical feature of the penalty issue is how they are imposed. Many penalties are computer-generated. That is, they are not the result of one human being evaluating another's tax return, but simply a man-made letter. This can lead taxpayers to believe that penalties are being asserted by the IRS in order to create a bargaining chip for itself.

Mr. Chairman, today's witnesses can tell us how the current penalty system is operating. We can compare how the system is operating to our vision of how it should operate. The recurring question is whether penalties should be designed primarily to reinforce compliance or whether they are a revenue source.

Penalties are intended to improve compliance and so taxpayers should be able to understand them so they can avoid paying it by doing the right thing. If penalties are intended to raise revenue, then there may be some perverse logic in keeping the penalty system complex and confusing. That may raise more penalty revenue but it also will raise taxpayer hostility and hard feelings.

In the long run, this is not the responsible way to operate a tax system. I look forward to hearing today's witnesses.

Chairman PICKLE. We will proceed with the witnesses. Commissioner Gibbs, we will ask you to proceed. I recognize that we have with us Judge Samuel B. Sterrett, Chief Judge of the U.S. Tax Court. We want to come back to you in spite of what we hear today or because of it.

Commissioner Gibbs, why don't you start. Do each of you have a statement, or do you want to participate in the panel?

Commissioner, I guess you have a statement.

STATEMENT OF HON. LAWRENCE B. GIBBS, JR., COMMISSIONER OF INTERNAL REVENUE, ACCOMPANIED BY CHARLES BRENNAN, DEPUTY COMMISSIONER (OPERATIONS), AND RICHARD STARK, ASSISTANT TO THE COMMISSIONER, INTERNAL REVENUE SERVICE

Mr. GIBBS. I have a short statement.

Thank you, Mr. Chairman. I am happy to be with you this morning to discuss the subject of penalties. As you indicated, I will be leaving about 9:30. In my absence——

Chairman PICKLE. Mr. Gibbs, we are having a little trouble hearing you.

Mr. GIBBS. I will have to be leaving about 9:30, but in my absence, to my left and your right is Charly Brennan, our Deputy Commissioner for Operations, along with Dick Stark, the Chairman of our Penalty Study Group. They will be in here in my absence to answer whatever questions the subcommittee may have.

Mr. Chairman, our tax system in this country is remarkable. It works and, by and large, it works well. Because it works well, we all benefit. Now, in order for our tax system to continue to work, it requires the respect, confidence and support of all of us, whether we are in the private sector as taxpayers or practitioners or whether in the public sector as tax administrators or tax legislators.

In order for the system to command respect, confidence and support, its rules must be understood, believed to be fair and enforced. Why? Because in order for people to comply with the tax laws, they must be able and willing to do so. It is no secret that over the last 15 or 20 years compliance with our tax laws has eroded somewhat as have respect, confidence and support for the system itself.

I believe that history will record that all of us in the public and private sectors must share in some of the blame for this erosion. Over the last 10 to 15 years, taxpayers generally have become more aggressive as have tax practitioners, particularly with the impact of high marginal tax rates, fueled by inflation and the early absence of economic sanctions which encouraged participation in the so-called audit lottery and underground economy.

During the last decade, Congress responded to signs of growing noncompliance with ad hoc sanctions and openly encouraged the IRS to use them to punish or deter noncompliance and more recently to increase revenue. In this connection I would like to quote from a report from the Joint Committee on Taxation respecting the 1984 Deficit Reduction Act where the Congress specifically instructed that:

> The Service should assert, without hesitancy, in appropriate circumstances the penalties that Congress has provided. In particular * * * the negligence and fraud penalties are not being applied in a large amount of cases where their application is fully justified.

The Internal Revenue Service has responded particularly in the tax shelter area with tough regulations, litigation positions, penalty assertions and computer-generated assessment and collection notices. The tension in our system, increased on both sides of the table and, yet, Mr. Chairman, I see signs of hope beginning to emerge. With the passage of the 1986 Tax Reform Act, we have reduced marginal tax rates, broadened the tax base and reenforced it with strong alternative minimum taxes.

Most importantly, we have eliminated tax shelters or virtually so. We are beginning to be as concerned about people's ability to comply with our tax laws as we have been about their willingness to comply. I think this is indicated by better funding of the IRS programs on the taxpayer service side of the organization and this subcommittee has supported that instinctively for which we are grateful.

There is a growing emphasis on the need to simplify the tax law and make it more administrable. Hopefully, there will be a willingness to take the time to get to root causes of problems before making legislative and administrative changes to solve the problems, and I think this hearing today indicates your willingness to do that.

We at the Internal Service are emphasizing the importance of providing quality and service, doing the right job right and not just collecting dollars. Finally, I am pleased and heartened with the cooperation that we have received this past year from taxpayers, practitioners, the Congress and the media working together to help us at the IRS carry out tax reform in the context of the current filing season and over the next several years.

Because of my concerns over the past 15 years and my hopes with the events of the last 2 years, I convened a group within the IRS last year to review the structure and administration of the penalty provisions as they exist in the Internal Revenue Code today. The purpose of this review is threefold.

First, to attempt to identify a set of principles from which to build a sound framework for the administration of penalties; second, to identify existing penalties that require modification, consolidation or repeal; third, and finally, to identify IRS practices and procedures that should be changed or improved to facilitate or make more equitable our administration of the penalty provisions.

We hope to begin reporting our findings by the end of this year. The task force is made up of a cross-section of Internal Revenue Service employees from our field and national office functions. They are working closely with the American Bar Association Taxation Section, the American Institute of Certified Public Accountants Tax Division, Tax Executives Institute, National Society of Public Accountants, and National Association of Enrolled Agents, as well as other professional, academic and business groups.

Mr. Chairman, I began by commenting that our tax system is remarkable. Let me close by observing that in the coming year we expect our gross Federal tax revenues to exceed $1 trillion for the first time in our Nation's history, a truly remarkable achievement. But even more remarkable, I think, is the fact that out of the $1 trillion we expect to pay American taxpayers some $90 billion in refunds, largely based on the returns that they prepare and send to us, and before we verify the accuracy of those returns.

Mr. Chairman, our tax system, in fact, is working today in this country, and I look forward to working with you and the other members of the subcommittee and other Members of Congress in the coming months to find ways to make it work even better.

Thank you.

Chairman **PICKLE**. Thank you, Commissioner. That is a very summarized statement. We will be discussing these points further.

[The statement of Mr. Gibbs follows:]

STATEMENT OF
LAWRENCE B. GIBBS
COMMISSIONER OF INTERNAL REVENUE SERVICE
BEFORE THE
SUBCOMMITTEE ON OVERSIGHT
COMMITTEE ON WAYS AND MEANS
March 31, 1988

Mr. Chairman and Members of the Subcommittee:

I appreciate your invitation to comment on the penalty structure in our Internal Revenue Code, a topic of great importance to the public, to practitioners, and to IRS. With me are Charles Brennan, Deputy Commissioner (Operations), and Richard Stark, Assistant to the Commissioner. Mr. Stark chairs our Task Force which is reviewing civil sanctions. We will be pleased to respond to the Subcommittee's questions following my testimony. Today, I want to share our concerns about the current penalty structure and provide information on the penalty study that IRS is conducting.

THE CHANGING TAX ENVIRONMENT

Our voluntary tax system in this country is remarkable. By and large, it works very well. Indeed, the vast majority of taxpayers file their returns, pay their taxes, and receive their refunds without an audit of their records. In order for our tax system to continue to work, it will require the respect, confidence, and support of all of us, whether we are from the private sector as taxpayers, practitioners, or members of the media, or whether we are from the public sector as tax legislators or tax administrators.

Over the last 15 years, some taxpayers and practitioners have become more aggressive in seeking to reduce tax liabilities. The impact of high marginal tax rates, fueled by periodic inflation, and the absence of economic sanctions encouraged many taxpayers to participate in questionable tax shelters as well as the so-called "audit lottery" and "underground economy."

During the last decade, the Administration and Congress responded to the signs of growing noncompliance by supporting the addition of many new penalties to the Internal Revenue Code. Congress openly encouraged the Internal Revenue Service to use them to punish and deter noncompliance and, more recently, to increase revenue. In this connection, I would like to quote from the Report of the Joint Committee on Taxation on the 1984 Deficit Reduction Act where Congress specifically instructed that, "The Service should assert, without hesitancy, in appropriate circumstances, the penalties that Congress has provided. In particular, ... the negligence and fraud penalties are not being applied in a large amount of cases where their application is fully justified." IRS has responded to this Congressional direction, particularly in the tax shelter area, by issuing firm regulations, adopting strong administrative and litigating positions, and adding a number of penalties together in particular instances.

Tensions in the system have increased to the point of frustration, anxiety, and distrust on both sides of the table, even to the point that taxes often have become high drama and good press for the print and electronic media.

And yet, Mr. Chairman, I see signs of hope beginning to emerge. With the passage of the 1986 Tax Reform Act, we have reduced marginal tax rates, broadened the tax base, and reinforced it with strong alternative minimum taxes; and most importantly, with the passive activity losses and other provisions in the 1986 Act, the new law has virtually eliminated tax shelters.

Another sign of hope is the increased concern within the Administration and Congress about people's ability to understand and thereby comply with our tax laws. An indication of this trend is the support of this committee and others for better funding of the Internal Revenue Service programs in the taxpayer assistance and education area. Additionally, there's a growing emphasis on the need to simplify the tax law and make it more administrable, and hopefully a willingness to get to root causes of problems before making legislative and administrative changes that attempt to solve the problems.

We at the Internal Revenue Service are emphasizing the importance of providing quality and service to our customers, doing the right job right and not just collecting tax dollars. This renewed emphasis on quality and service is already beginning to produce solutions to difficult problems. We are excited about the long-term potential of our quality programs.

Finally, I am pleased and heartened by the cooperation that we have received over the past year from taxpayers, practitioners, Congress, and the news media, working together to help us at the Internal Revenue Service prepare to carry out tax reform in the context of the current filing season and over the next several years.

THE IRS PENALTY STUDY

Because of many of my concerns over the past 15 years and my hopes with the events of the last two years, I convened a group within the Internal Revenue Service last year to review the structure and administration of the penalty provisions in the Internal Revenue Code. The purpose of this review is threefold:

- to develop a set of principles from which to build a sound framework for the administration of penalties;
- to identify existing penalties that require modification, consolidation, or repeal; and
- to identify IRS practices and procedures that should be changed or improved to facilitate and make more equitable our administration of the penalty provisions.

Our task force is well into its work, and we hope to begin reporting on its findings by the end of the fiscal year. The task force is made up of a broad cross section of Internal Revenue Service employees from our field and national office functions; and they are working closely with their counterparts in the private sector: representatives of the American Bar Association Taxation Section, the AICPA Tax Division, Tax Executives Institute, the National Society of Public Accountants, the National Association of Enrolled Agents, and other similar professional, academic, and business groups.

Because the penalty study is not yet concluded, I cannot give you any recommendations today. However, I would like to discuss some of the concerns with the current penalty system which are key to our study.

Our chief concern is that the current statutory penalty structure lacks a coherent framework; instead, it reflects the piecemeal way it was built over the last twelve years. Typically, a compliance problem was identified, and a penalty was constructed to address that problem, or an existing penalty was made more severe. The specific problems that these additional penalties were targeted to address were viewed as so serious that more general concerns about the direction of the civil sanction system as a whole and the increased emphasis on penalties were not critically assessed.

This lack of a coherent framework creates other difficulties:

- New penalties get added that overlap existing penalties;
- The resulting complexity makes the system hard to understand and administer;
- The IRS has to issue additional regulations that, by their very existence, add complexity to the penalty structure;
- The stacking of several penalties on the same act often leads to harsh results. Penalties that are viewed as too tough may cause taxpayers to question the fairness of our tax system because the punishment is out of proportion to the seriousness of the penalized act.
- The complicated computations for some penalties along with the different statutory standards of application and waivers are difficult to apply with consistency, leading to skepticism about the system's fairness.

Taxpayers' attitudes are extremely important in a voluntary compliance system. A penalty system based on the wrong principles may provide appropriate sanctions for some types of behavior and yet have an overall negative impact on taxpayer behavior because the system is not perceived as fair.

That is why civil sanctions need to be approached as a coherent whole. We need to develop a widely accepted set of assumptions about what a civil penalty can and should be used for. What is an appropriate purpose for a penalty? Is it to assure the compliant taxpayer that noncompliance is not advisable? Is it to punish the noncomplier? Should civil sanctions be used to raise revenues? These issues need to be raised, discussed, and, if possible, resolved.

In addition to the questions of purpose, there are many other issues that need to be resolved in building a coherent framework for penalties. What are the characteristics of a penalty that does a good job of fulfilling its purpose? Should penalties be simple, or is complexity either permissible or unavoidable? How important is simplicity, particularly if it conflicts with fairness? In appropriate cases should first-time violators be let off with a warning? What is the appropriate severity of a penalty? As the penalty increases in severity, it may more effectively prevent objectionable conduct, but at some point we all may agree that the anger, frustration, or fear that is created means that a lower level of severity is appropriate.

How much leeway should the IRS have to abate or forgive the penalty? Is it better for the penalty to be asserted in all cases that meet specific criteria, or should the IRS have discretion not to assert penalties? If so, how broad should this discretion be? Are there things IRS can do to reach some behavior that is now penalized in other ways? Should there be more educational programs on the substantive tax law? New or changed publications or forms? Additional training for our personnel? More legal guidance? Different assertion and abatement procedures?

All of these issues need to be explored, and conclusions reached and understood from the perspective of all concerned, which in my view includes practitioners, taxpayers, lawmakers, and administrators. The issues are not simple, and the tradeoffs needed are not obvious. I expect our IRS penalty task force to have recommendations on these questions.

One issue you asked us to address is the rate at which IRS abates penalty assessments. In Fiscal year 1987, IRS assessed just under 27 million penalties involving over $14 billion. In that same year, we abated approximately 4 million penalties totalling in excess of $4 billion. Let me caution that these abatement figures do not necessarily mean that IRS is making a lot of mistakes.

Many penalties are assessed on the basis of information furnished with the return being processed and on any information already in our computer systems. The taxpayers may have other information, not provided to us, that would cause us not to assert a penalty. However, we have no way of knowing until the taxpayer provides the information. When taxpayers receive a notice or bill for a penalty, we also tell them how to respond to us if they do not agree. We have many responses to our notices, and, where appropriate, we abate the assessed penalty based on the additional information furnished by the taxpayer.

For example, a taxpayer may provide an explanation that establishes reasonable cause so that a late filing penalty may be waived. Additionally, the amount of many penalties depends on the amount of an underlying tax liability, and any adjustment of that tax liability will automatically trigger an adjustment of the penalty. Thus, frequently the filing of an amended return will cause an automatic abatement.

To some extent, we think the numbers of abatements are a healthy sign that taxpayers have sufficient opportunity to let us know when a penalty is not appropriate. However, we also believe that a reduction in the number of abatements by improving the information and procedures used in asserting penalties would be desirable. Our penalty study in looking at this area.

INTERIM MEASURES

Even though I am waiting for the IRS penalty study to be completed before providing recommendations to change our current system, I want to point out that we have waived certain penalties connected with the filing of 1987 returns. We did so because of the multitude of new rules that taxpayers face in the first year of tax reform and the difficulties we had with the Form W-4, Employee's Withholding Allowance Certificate.

First, in December, we announced a waiver of estimated tax penalties for individuals who are underwithheld on income tax for wages for 1987. Secondly, this year, we will not penalize those who do not report on their return a social security number for dependents five years of age or older. Thirdly, if an individual taxpayer is penalized for a mistake that was caused by erroneous advice given by an IRS employee, the penalty can be waived.

I believe that our action on these penalties dealt with some of the fairness and harshness questions that we need to resolve in developing an overall framework for penalties. It underscores the fact that the proper use of civil penalties is in deterring noncompliance, not penalizing those who are trying to comply with their legal tax obligations.

CONCLUSION

Mr. Chairman, there is clearly enough blame to go around with respect to our current civil penalty structure. The aggressive activity of some taxpayers and practitioners brought the enactment of new penalties that we at IRS have firmly enforced.

Today's post-tax-reform environment presents an excellent opportunity to improve the civil penalty structure and administration. It is my hope that, through the effort IRS began last year and through Congressional efforts, we can begin to develop a framework of general principles or standards for each group of penalties in the Code. With the assistance of practitioner groups, the academic community, and taxpayers, our efforts hold great promise.

My colleagues and I will be happy to respond to questions you and the members of your Subcommittee may have today.

Chairman PICKLE. I want to recognize Dennis Ross, Deputy Assistant Secretary for Tax Policy for the Department of Treasury.

STATEMENT OF DENNIS E. ROSS, DEPUTY ASSISTANT SECRETARY (TAX POLICY), U.S. DEPARTMENT OF THE TREASURY

Mr. ROSS. Thank you, Mr. Chairman. I, too, appreciate the opportunity to be here and discuss with you today our civil penalty structure and present the views of the Treasury Department on those questions. If the review of this subcommittee can help limit the complexity and improve the fairness of our civil tax penalties, certainly all the taxpayers and the tax system generally will be the beneficiaries.

The subcommittee's hearing comes at a very appropriate time. As you noted, Mr. Chairman, Congress has just completed a fundamental reform of the substantive tax rules, and a comprehensive assessment of the role of tax penalties is a natural second step. In undertaking that assessment, we face a tax penalty structure that has grown very significantly in size, often in piecemeal fashion. It is now a frequent source of taxpayer complaints. At this point in the review process, we can only provide a framework for a analysis since much remains to be done in developing information about how the penalty system and particular penalties work in practice.

We look forward, however, to working with this subcommittee during the course of its review, in contributing to the development of any necessary reforms to the civil tax penalty system. Mr. Chairman, to understand the function of civil tax penalties in our system, it is first necessary to have an overall sense of how our collection system works.

Essentially, we collect taxes in three ways: Through voluntary payment of taxes by taxpayers themselves, through withholding by third parties and through collection of taxes by the Service where they are not voluntarily paid or withheld. By far the most important function of civil tax penalties is to encourage voluntary compliance.

The majority of taxpayers recognize the importance of paying taxes and voluntarily accept that responsibility. There remain, however, significant groups who would carelessly disregard the rules or avoid all together their obligation to pay tax. Tax penalties serve to deter such noncompliance. Moreover, the penalties imposed on noncompliance reenforce the honest taxpayers' ordinary instinct to comply, by providing assurance that noncompliance will not be tolerated, and thus, that the burden of taxes is fairly distributed.

Although the tax penalty system's primary function is to act as a deterrent to noncompliance, it must also operate fairly with respect to that great majority of taxpayers who do voluntarily comply. Our system should thus not penalize those who have not behaved wrongfully nor overpenalize those whose compliance is inadvertent.

The penalty system must have been designed to minimize administrative difficulties for compliant taxpayers. The penalty system is designed basically to promote both a timely reporting and payment of tax and also the accurate reporting of taxable income. The necessary first step to collecting revenues is to obtain the taxpayer's statement of the amount due and also the payment of that amount. As you know, there currently are penalties for failure to file a return and failure to pay the amount properly owned. The issues raised by these penalties are fairly straightforward, since it is generally clear when and to what extent they are applicable.

What needs to be considered here is whether these penalties effectively encourage timely reporting and do so in a manner that is basically fair.

Penalties for inaccurate reporting raise a more difficult question. The current penalties for inaccuracies reflect two different basic approaches: One, a traditional tort law concept of fault and the other focusing on the strength of the taxpayer's legal position, without regard to traditional concepts of fault. Historically the fault based civil negligence and fraud penalties bolstered by criminal fraud penalties as necessary, served as the mainstay of tax law enforcement efforts.

As elsewhere in the law, negligence exists where the taxpayer fails the standard of reasonableness; that is, where there is no reasonable basis for the return position. Generally fraud exists where the taxpayer's behavior is clearly wrongful and there is an intentional evasion of tax. These were the only generally applicable penalties to assure taxpayers accurately reported the amount of tax.

The second type of penalties grew out of a belief that penalties triggered only by negligent or fraudulent behavior would not adequately assure that taxpayers reported their income accurately. The complexity of the substantive rules has inevitably created large gray areas consisting of arguably correct positions with varying degrees of support.

Standing alone, negligence or fraud standard places relatively little tension on a taxpayer's decision to take an aggressive position in an area of legal or factual uncertainty, since the taxpayer's aggressiveness can often avoid penality in the event of audit and is rewarded if the taxpayer is among the majority of taxpayers not audited.

As a consequence, we now impose penalties on taxpayers found to have taken aggressive positions without substantial legal support. The most significant of such penalties was adopted in the Tax Equity and Fiscal Responsibility Act in 1982, the penality imposed on the portion of an underpayment attributable to a substantial understatement of tax liability.

This penalty is now 25 percent of the portion of any significant understatement not supported by substantial authority or, except in the case of tax shelters, not adequately disclosed on the return. The substantial authority standard effectively requires that the taxpayer have more than a reasonable basis for his return positions, thus placing the taxpayer at risk even though his behavior is not wrongful under traditional standards.

The concerns leading to the substantial understatement penalty have been especially pronounced in the tax shelter area. This has led to a number of penalties dealing with taxpayers participation in tax shelters and similar transactions. Thus, the substantial understatement penalty applies on a more stringent basis to certain tax shelter items reported by a taxpayer with a principal purpose of avoiding paying tax.

A substantial undervaluation penalty applies to individuals and certain corporations underpaying taxes due to the use of an inflated value or tax basis for property. There is a new civil penalty which applies to any underpayment attributable to tax motivated transactions.

Mr. Chairman, although we are focusing on the civil penalties applicable to taxpayers today, it should not be forgotten that many of the civil tax penalties apply to obligations unrelated to a taxpayer's own tax liability. These penalties are in fact a source of many complaints we hear about the penalty system.

Because withholding is a critical part of the collection system, failure to withhold on a timely basis is subject to penalty. Similarly, information reporting has come to play an increasingly important role in tax compliance, and penalties have been established for a failure to file an information return, a failure to provide a copy of such return to the taxpayer and a failure to provide correct information on a properly filed return.

A number of penalties buttress those imposed on nontaxpayers—I should say, on the taxpayer, for a failure to report accurately. Thus return preparers are penalized for negligence or intentional understatement of a taxpayer's liability. There is a civil penalty for aiding and abetting the understatement of tax.

A number of nontaxpayer penalties focus on those who market and promote tax shelters: Failing to register an investment deemed to be a tax shelter, and failing to maintain an investor list respecting a tax shelter.

Mr. Chairman, having identified in general terms the role for penalties, and the most significant of the current existing civil tax penalties, let me suggest a number of the issues that should be addressed during the course of your subcommittee's review.

Examination of the civil penalty system should begin with its increasingly complex legal structure. Such complexity is itself a matter of concern. Penalties will not be effective unless understandable by taxpayers and the IRS personnel responsible for asserting them. The interrelationship of the various penalties must also be examined with a view to eliminating gaps in coverage or penalties that inappropriately overlap.

There are, for example, several different penalties potentially applicable to the taxpayer for participation in a single tax shelter transaction, which may overpenalize such behavior. In this regard, it would be appropriate to examine the severity of individual penalties and to consider whether first-time offenders should be treated more leniently than others.

Reviewing the civil penalty system must focus on the manner in which penalties are being administered. There specific issues appear to merit particular attention: First, is whether the computerized assertion of certain penalties result in an unfair burden on persons against whom no penalty is ultimately assessed.

Second, whether the assertion of overlapping penalties and large penalties has in practice distorted the administrative procedures designed to resolve disputes between taxpayers and the IRS, because such penalties inevitably become part of the tax revenue at stake in such disputes. Finally, there is a question of whether the understatement penalty in practice penalizes taxpayers who have made errors merely that are inadvertent.

Finally, Mr. Chairman, in reviewing the civil penalties system we need to keep in mind that penalties are but one of a number of administrative tools that promote compliance. Thus, the taxpayer assistance programs and the public forms, regulations and rulings can all promote accuracy and encourage or reenforce positive efforts by taxpayers to abide by the laws.

Such instruments are particularly important in times when substantive changes force taxpayers to reassess their conduct for the future. In conclusion, let me say that we look forward to working with this subcommittee, with the IRS and others in seeking to find answers to the questions raised by our existing civil penalty system.

Thank you.

[The statement of Mr. Ross follows:]

For Release Upon Delivery
Expected at 9:00 a.m., E.S.T.
March 31, 1988

STATEMENT OF
DENNIS E. ROSS
DEPUTY ASSISTANT SECRETARY (TAX POLICY)
DEPARTMENT OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON OVERSIGHT
COMMITTEE ON WAYS AND MEANS
U. S. HOUSE OF REPRESENTATIVES

Mr. Chairman and Members of the Subcommittee:

I appreciate this opportunity to appear before you today to present the views of the Treasury Department concerning efforts by your Subcommittee, the Internal Revenue Service and others to review our existing civil tax penalties with the aim of improving their operation. We welcome this attention to one of the most important aspects of our system of tax administration. To the extent that means can be discovered to eliminate unnecessary complexity and improve the fairness and effectiveness of our civil tax penalties, all taxpayers and the tax system will benefit.

NEED FOR COMPREHENSIVE REVIEW

The Treasury Department supports a thorough review of the existing tax penalty structure. Congress has just completed a fundamental reform of the substantive tax rules to promote fairness, simplicity and economic growth; a comprehensive assessment of the role of existing tax penalties is a natural second step in the effort to improve our tax laws. There has been no recent attempt to examine the fundamental assumptions underlying the various tax penalties and to determine whether each penalty is accomplishing its intended goals. The tax penalty structure has grown piecemeal over time, often incident to substantive changes and without full consideration of the interrelationship between different penalties. Moreover, many of the recent substantive reforms, particularly those intended to discourage tax shelter activities, may permit revisions to the penalty rules.

In addition, there are other indications that a reassessment of the structure and administration of our civil tax penalties is necessary. The Treasury Department has received frequent taxpayer complaints about the fairness of tax penalties. Often, in speaking before taxpayer groups, I am asked what we intend to do about the problems with our penalties. We also understand from our counterparts at the Internal Revenue Service that those who administer our penalties have encountered some difficulties.

At this point in the process, we can only provide a framework for analyzing the proper role of tax penalties and point to certain of the specific issues that we believe should be addressed. We will cooperate fully with this Subcommittee in its review of the tax penalty system and look forward to working with the Congress in developing any necessary reforms.

ROLE OF PENALTIES IN TAX SYSTEM

To understand the function of civil tax penalties in our tax system, it is first necessary to have an overall sense of how our tax collection system works. There are essentially three ways in which taxes are collected: voluntary payment of taxes by the taxpayers themselves; withholding by third parties of tax owed by taxpayers; and collection of taxes by the Service where they are not voluntarily paid by taxpayers or withheld by third parties.

Promotion of Voluntary Compliance

By far the most important function of civil tax penalties is to promote voluntary compliance. The majority of taxpayers recognize the importance of paying taxes, and voluntarily accept their responsibility to do so. There remains, however, a significant group of taxpayers who would carelessly or recklessly disregard the rules or knowingly understate or avoid altogether their obligation to pay tax. Tax penalties serve to deter such noncompliance. Moreover, the penalties imposed on noncompliance reinforce the honest taxpayer's ordinary instinct to comply, by providing assurance that noncompliance is not tolerated and thus that tax burdens are fairly distributed.

Fair Application to All Taxpayers

Although the tax penalty system's primary function is to act as a deterrent to noncompliance, it must also operate fairly with respect to the majority of taxpayers who comply with the tax laws. Our system should not penalize those who have not behaved wrongfully, nor overpenalize those whose noncompliance is inadvertent or relatively minor in nature. In addition, the penalty system should be designed so as to minimize administrative difficulties for such taxpayers. At some point, compliance itself would be jeopardized by a poorly devised penalty system that alienated otherwise law-abiding taxpayers. Thus, as we re-examine the penalty structure, we must pay careful attention to the perceived fairness of the civil tax penalties, particularly given that for some taxpayers the process of adapting to recent substantive changes in the tax law has made voluntary compliance more difficult.

CIVIL PENALTIES APPLICABLE TO TAXPAYERS

The civil penalty system is designed to promote two basic types of behavior by taxpayers: first, the timely reporting and payment of tax; and second, the accurate reporting of taxable income. The problems associated with these two types of compliance vary significantly in their complexity.

Timely Reporting and Payment of Tax

The essential first step in collecting revenues is to obtain the taxpayer's statement of the amount due and the payment of that amount. There currently are penalties for failure to file a return and for failure to pay the amount properly owing. Neither penalty applies in the case of a failure due to reasonable cause.

The failure to file penalty runs at 5 percent per month of the tax owing after subtraction of payments made on or before the due date of the return and of credits, up to a maximum of 25 percent. The separate failure to pay penalty is generally equal to 1/2 percent per month of the amount of tax owing for a month, determined by subtracting any payments made on or before the beginning of such month and credits. The 1/2 percent rate increases to 1 percent per month with respect to certain accounts in the collection stage, but the maximum penalty that may be imposed is 25 percent of the amount unpaid. With respect to amounts that the taxpayer shows on the return but fails to pay, the penalty runs from the date that payment is due. With respect to amounts for which a notice and demand is made, the penalty runs from the tenth day following notice and demand.

The penalty for failure to pay estimated taxes in large part serves as a means of taking into account the time value of money. To the extent it plays this role, it should not be analyzed in the same manner as other penalties.

Even though we believe a careful reassessment of the penalties associated with reporting and payment is appropriate, we anticipate that the issues encountered with respect to such penalties will prove relatively straightforward. It will generally be relatively easy to determine when the taxpayer has failed to report and pay taxes in a timely manner. The question simply is whether timely reporting and payment is encouraged by our penalty structure within a framework of fundamental fairness.

Accurate Reporting of Tax Liability

In contrast to the penalties relating to timely reporting and payment, the problems posed by the penalties relating to the accurate reporting of tax liability by the taxpayer are significantly more difficult. Two different basic approaches to such penalties have been adopted, one primarily relating to the behavior and state of mind of the taxpayer, and the other relating to the strength of the taxpayer's legal position. In both cases difficult questions of line drawing have inevitably been confronted.

Negligence and fraud penalties. Historically, tax penalty standards focused on the taxpayer's behavior and state of mind, with the civil negligence and fraud penalties, bolstered by criminal fraud penalties as necessary, the mainstay of tax law enforcement efforts. Until recent years these were the only generally applicable penalties designed to ensure that taxpayers accurately reported the amount of tax owing.

The negligence penalty applies if a taxpayer fails to make a reasonable attempt to comply with the tax laws or carelessly, recklessly, or intentionally disregards the applicable rules. Today, the negligence penalty stands at 5 percent of the entire underpayment of tax, plus 50 percent of the interest payable on the portion of the underpayment attributable to negligence. Negligence is presumed to be present with respect to an item, absent clear and convincing evidence to the contrary, if the taxpayer fails to properly report an amount shown on an information return prepared by a third party. However, the negligence penalty extends by reason of such negligence to only that portion of the understatement attributable to the misreported item.

The civil fraud penalty generally is imposed only when the taxpayer's behavior extends substantially beyond a failure to take reasonable care in the preparation of the required return and involves an intentional or reckless underpayment of taxes owed. This penalty is currently equal to 75 percent of the portion of the underpayment attributable to fraud, plus 50 percent of the interest payable on this portion of the underpayment.

Substantial understatement penalty. Over time, it became apparent that penalties triggered only by negligent or fraudulent behavior could not adequately assure that taxpayers reported their income accurately. The relative complexity of the system's substantive rules inevitably created large gray areas consisting of arguably correct positions with varying degrees of support. Sophisticated taxpayers were able to take very aggressive positions in areas of legal or factual uncertainty, with no risk of penalty unless the position reported was without a reasonable basis. This standard placed relatively little tension on a taxpayer's decision to take an aggressive position, since the taxpayer's aggressiveness could often avoid penalty in the event of audit, and would be rewarded if the taxpayer were among the great majority of taxpayers not audited.

As a result of the perceived imbalance resulting from the historical approach, new penalties were adopted in the 1980's to impose a cost on those audited and found to have taken aggressive positions on their return that did not have substantial legal support. Perhaps the most significant such penalty was adopted in the Tax Equity and Fiscal Responsibility Act of 1982, the penalty imposed on the portion of an underpayment attributable to a "substantial understatement" of tax liability. This penalty was 10 percent initially and is now 25 percent. For purposes of determining whether the gap between the liability the taxpayer reports and the correct liability is a substantial understatement, the portion of the understatement of tax attributable to positions taken on the tax return that are supported by substantial authority (which is more than a "reasonable basis" but not necessarily "more likely than not") or that are adequately disclosed on the return are disregarded unless the positions relate to certain tax shelter items discussed below. Under this penalty, then, unless the taxpayer discloses the matter on his return or has considerable support for his position, a penalty can be imposed irrespective of negligence or fraudulent intent or recklessness. Of course, the IRS may waive part or all of the penalty upon a showing of good faith and a reasonable basis for the position.

Tax shelter penalties. Concerns over the adequacy of the historical penalty standards were especially pronounced with respect to transactions expressly designed to exploit the disparities between tax and economic measurements of income or loss. The growth in such transactions and the taxpayer aggressiveness associated with them gave rise to a perceived need to strengthen the penalties applicable to "tax shelters."

As a consequence of this perception, several penalties have been adopted in recent years dealing primarily with taxpayers' participation in tax shelters and similar transactions, including a special part of the substantial understatement penalty. With respect to certain tax shelter items reported by a taxpayer with the principal purpose of avoiding or evading tax, the existence of a substantial understatement is calculated by disregarding only those positions taken on the return that the taxpayer reasonably believed were more likely than not to prevail and that were also supported by substantial authority.

In addition, the substantial undervaluation penalty was enacted in the Economic Recovery Tax Act of 1981 to apply to individuals and certain corporations underpaying income tax by $1,000 or more due to use of an inflated value or tax basis for property equal to 150 percent or more of the correct value. This penalty is 10 percent of the underpayment of tax attributable to an overvaluation of at least 150 percent but not more than 200 percent, 20 percent of the underpayment attributable to an overvaluation of more than 200 percent but not more than 250 percent, and 30 percent of the underpayment attributable to an overvaluation of more than 250 percent. A similar penalty is imposed for undervaluation for purposes of the estate tax. If the taxpayer shows that there was a reasonable basis for the position taken on the return and good faith, the IRS may waive part or all of these penalties.

Finally, an additional new civil tax penalty applies to underpayment attributable to "tax motivated transactions" after the Tax Reform Act of 1984. If such underpayment exceeds $1,000, the interest rate applicable to it is 120 percent of the underpayment rate.

PENALTIES APPLICABLE TO NONTAXPAYERS

Although we are focusing today primarily on the civil penalties applicable to taxpayers, it should not be forgotten that many of the civil tax penalties apply to persons with obligations unrelated to their own tax liability. In fact, many of the complaints which we hear about the penalty system relate primarily to these penalties.

Accurate withholding and deposit of trust taxes

Because withholding is critical to the collection of large amounts of revenue without the need for significant governmental enforcement efforts, a penalty applies to any amount that is not deposited on a timely basis by the person responsible for withholding. The penalty (which also applies to certain payroll taxes other than those withheld) is 10 percent of the amount that is not deposited on time. In addition, any person required to withhold an amount that willfully fails to withhold and pay over such amount is liable for it in full.

Information reporting

Information reporting with respect to the income and deduction items of other taxpayers also has played an increasingly important role in recent efforts to improve compliance. To ensure that the obligations to report accurately and on a timely basis are taken seriously, there are penalties for failure to file an information return, failure to provide a copy of such return to the taxpayer, and failure to provide correct information on a properly filed return.

Penalties applicable to parties who may affect another taxpayer's reported tax liability

A number of penalties buttress those imposed on the taxpayer to achieve accurate reporting. Return preparers are penalized for negligent or intentional understatement of a taxpayer's liability. In addition, there is a civil penalty for aiding and abetting a taxpayer's understatement of tax.

Moreover, among the newer penalties are several intended to limit the activities taken by those who would profit from the marketing of tax benefits. There are penalties for promoting an abusive tax shelter, failing to register an investment deemed to be a tax shelter, and failing to maintain an investor list with respect to a tax shelter.

ASSESSMENT OF THE CURRENT SYSTEM

Having identified in general terms the role for penalties and the most significant existing civil tax penalties, it is appropriate to turn to an assessment of the current civil penalty system. Although it would be premature to suggest conclusions, we are aware of a number of concerns that should be addressed during the course of your review.

Structure of Penalties

Review of the civil penalty system should begin with its increasingly complex legal structure. Such complexity is itself a matter of concern, since penalties will not be effective unless understandable by taxpayers, other private parties, and the IRS personnel responsible for asserting them.

The interrelationship of the various penalties must also be examined, with a view to eliminating gaps in coverage or penalties that inappropriately overlap. There are, for example, several different penalties potentially applicable to a taxpayer from participation in a single tax shelter transaction. In addition, it may prove desirable to fold certain specific penalties into a more generic penalty devised to encompass a number of situations.

Each penalty should also be evaluated to determine whether the severity of the penalty is appropriate in light of the conduct sought to be encouraged. The application of multiple penalties may be unduly severe in some cases. Similarly, it may be advisable to consider whether first-time offenders should be treated more leniently than those repeating the behavior targeted by the penalty.

Administration of Penalties

Review of the civil penalty system must also focus on the manner in which penalties are being administered. Independent of the legal structure of the penalty system, uniform application of each penalty to similarly situated taxpayers is of obvious and critical importance. It should also be determined whether specific penalties are either asserted too frequently or ignored to the detriment of the system. In this connection, review should focus on the manner in which penalties are generated and the administrative procedures necessary to monitor the effectiveness of penalties on an ongoing basis.

Three specific issues relating to penalty administration appear to merit particular attention. First is whether the computerized assertion of certain penalties results in an unfair burden on persons against whom no penalty is ultimately assessed. Second is whether the assertion of overlapping penalties and large penalties has, in practice, distorted the administrative procedures designed to resolve disputes between taxpayers and the IRS because such penalties inevitably become part of the tax revenue at stake in such disputes. Finally, there is a question whether the "no-fault" substantial understatement penalty in practice penalizes taxpayers who have made inadvertent errors.

Penalties as One of Several Compliance Tools

In reviewing the civil penalty system, it should be kept in mind that penalties are one of a number of administrative tools that promote compliance. For example, the audit process has long played a role in ensuring that taxpayers' reported positions reflect the correct application of the tax laws. In addition, taxpayer assistance programs can promote accuracy and reinforce positive efforts by taxpayers to abide by the laws. Such programs are particularly necessary in times when substantive changes force taxpayers to reassess their conduct for the future. In the same vein, computerized reminders, form improvements and other efforts to make the rules known and understandable encourage taxpayer cooperation. Improvements to the administration of the information reporting program could also play an important role in the future.

Finally, there are fundamental compliance initiatives that could represent alternative solutions to some of the compliance problems that penalties attempt to address. Withholding at the source of payment remains the most cost-effective way of ensuring that taxpayers pay amounts due. In addition, rate reductions and substantive changes that broaden the tax base can be expected to reduce incentives and opportunities for misreporting the amount of taxes owing.

CONCLUSION

In the coming months we will work with the Subcommittee, the IRS and others seeking to find answers to the questions raised by our existing civil penalty system. I look forward to working with you as our mutual efforts progress.

Chairman PICKLE. Thank you, Mr. Ross.

Judge Sterrett, if you will proceed with the statement and we will ask you to pull that microphone up.

STATEMENT OF HON. SAMUEL B. STERRETT, CHIEF JUDGE, U.S. TAX COURT

Judge STERRETT. I also appreciate the invitation to appear this morning. As tax professionals, we all share the responsibility of doing all we can to ensure that the tax system is both fair in fact and fair in the perception of the taxpaying public.

The Tax Court has jurisdiction over relatively few of the penalties at issue this morning. Accordingly, I will limit my comments to those few that are frequently litigated in our court.

The negligence penalty is probably the most frequently litigated penalty in the court. A taxpayer is liable for this penalty if any part of an underpayment of tax is due to negligence or disregard of rules and regulations. The amount of the penalty was historically 5 percent of the underpayment.

However, the 1981 Tax Act bifurcated that penalty into two components. The amount of the penalty is now the sum of the historical amount and 50 percent of the interest payable on the portion of the underpayment attributable to negligence. Although this approach might be theoretically justified, it complicates the resolution of disputes involving the negligence penalty, thereby increasing the party's litigation costs.

Each adjustment made by the Commissioner must now be scrutinized in order to decide whether the underpayment it gives rise to is attributable to negligence. The second component of the penalty is time sensitive. The Commissioner is not in a position to determine the exact amount thereof, in a notice of deficiency. Therefore, the amount of this component of the penalty is described in statutory notice as "to be determined," and that, sir, gets taxpayers attention when he or she gets a bill of an unknown amount. We have had taxpayers in our court express fear, concern and outrage over the fact that they are involved in a dispute with the IRS where the parameters of the amounts in dispute are unknown.

The civil fraud penalty has also been within the Tax Court's jurisdiction for many years. A taxpayer is liable for this penalty if any part of any underpayment of tax required to be shown on a return is due to fraud. The amount of the penalty was historically 50 percent of the underpayment. However, the 1982 act bifurcated this penalty into two components. The amount of the penalty became the sum of the historical amount and 50 percent of the interest payable on the portion of the underpayment attributable to fraud. This approach is complicating the resolution of disputes involving the fraud penalty in exactly the same manner that it complicates resolution of disputes involving the negligence penalty.

The 1986 act further has added to the complexity of the fraud penalty. The amount of the penalty now is equal to the sum of 75 percent of the portion of the underpayment attributable to fraud and 50 percent of the interest on the portion attributable to fraud.

Both components of the penalty now demand that each adjustment made by the Commissioner be scrutinized in order to decide and determine whether the underpayment it gives rise to is attributable to fraud. If an underpayment of tax is partially attributable to fraud and partially to negligence, the fraud penalty, and therefore its two components, applies to the portion attributable to fraud and the negligence penalty, and therefore its two components, applies to the portion attributable to negligence.

This approach has the potential to turn each and every adjustment made by the Commissioner in a notice of deficiency into a battleground over the triple questions of whether or not a taxpayer was fraudulent, whether or not a taxpayer was negligent, or whether a taxpayer was merely negligent rather than fraudulent. Although this approach is conceptually logical, it adds to the burden of litigation.

There is also the matter of overlapping penalities. In a number of instances, Congress has explicitly indicated that two particular penalties are mutually exclusive. Thus, for example, if the fraud penalty is assessed, the delinquency penalty may not also be assessed, at least, on the part of the underpayment attributable to fraud. Similarly, If the fraud penalty is assessed, the negligence penalty may not be assessed respecting the portion of the understatement attributable to fraud. However, there are instances where penalties can apply concurrently. The delinquency and negligence penalties provide an example. Whether other penalties can apply concurrently is problematical.

For example, if a valuation overstatement is due to fraud, can both the fraud and valuation overstatement penalty be assessed with respect to the same underpayment? Given the proliferation of penalties in recent years, I think the question of concurrent penalties is one that will certainly arise. Because the touch-stone to decision is congressional intent and the best indication of congressional intent is statutory language, it would be helpful if Congress were to provide specific guidelines on this matter by indicating which penalties are mutually exclusive and which may co-exist.

Penalty legislation involves a delicate balance between too much and too little. I think few would argue that penalties should be completely eliminated. Certain types of tax behavior must be discouraged—fraud, for example—and appropriate penalties undoubtedly influence behavior.

On the other hand, every penalty carries a certain cost or burden, if you will. There is the administrative burden that the IRS bears in attempting to enforce a penalty. There is a burden placed on the courts in having to decide yet another matrix of issues in resolving a tax dispute between the Commissioner and a taxpayer. Finally, there is the greatest cost or burden of them all, the burden placed on voluntary compliance, the keystone of our self-assessment system, if the laws are perceived to be overly complex, unnecessarily numerous or simply unfair.

I therefore respectfully suggest that the Congress carefully weigh these costs or burdens when considering further the penalty legislation, in order to assure itself that the benefits justify the costs.

I would also respectfully request, on behalf of the court—which is, after all, the interpreter of congressional will—that as clear and thorough an expository intent as possible be set forth in the legislative history so we can comply with the mandate of Congress.

Mr. Chairman, it is not the role of the courts to attack or defend any substantive legislation. However, I must confess that, if called upon to do so, I could not defend the current penalty statutes.

Thank you, Mr. Chairman. I am delighted to be here, sir.

[The statement of Judge Sterrett follows:]

UNITED STATES TAX COURT

STATEMENT OF CHIEF JUDGE STERRETT BEFORE THE HOUSE SUBCOMMITTEE ON OVERSIGHT OF THE COMMITTEE ON WAYS AND MEANS

March 31, 1988

Mr. Chairman and members of the Committee, my name is Samuel B. Sterrett, and I appear in my capacity as Chief Judge of the United States Tax Court.

As tax professionals, we all share the responsibility of doing all we can to insure that the tax system is both fair in fact and fair in the perception of the taxpaying public. I therefore appreciate the opportunity to appear before you today, and I hope that my comments will prove helpful to you in reviewing the existing penalty system and instituting those changes that may be necessary to improve and strengthen it.

In preparing for this hearing I was struck by the tremendous number of penalties that are currently part of the Internal Revenue Code. The Tax Court has jurisdiction over a relatively few of these. Accordingly, I will limit my comments to those few that are frequently litigated in our Court.

Negligence Penalty

The negligence penalty is probably the most frequently-litigated penalty in the Tax Court. A taxpayer is liable for this penalty if any part of an underpayment of tax is due to negligence or disregard of rules and regulations. The amount of the penalty was historically 5 percent of the underpayment. However, the 1981 tax act (ERTA) bifurcated the penalty into two components.

The amount of the penalty is now the sum of the historical amount and 50 percent of the interest payable on the portion of the underpayment attributable to negligence. Although this approach may be theoretically justified, it complicates the resolution of disputes involving the negligence penalty, thereby increasing the parties' litigation costs. Now each adjustment made by the Commissioner must be scrutinized in order to decide whether the underpayment it gives rise to is attributable to negligence.

Because the second component of the negligence penalty is time sensitive, the Commissioner is not in a position to determine the exact amount thereof in a notice of deficiency. Typically, therefore, the amount of this component of the penalty is described in the statutory notice as "to be determined" or "50 percent of the interest due on the underpayment attributable to negligence" or "50 percent of the interest due on $_____." We have had taxpayers in our Court express fear, concern, and outrage over the fact that they are involved in a dispute with the Internal Revenue Service where the parameters of the amounts in dispute are unknown to them.

Fraud Penalty

The civil fraud penalty is another penalty that has been within the Tax Court's jurisdiction for many years. A taxpayer is liable for this penalty if any part of any underpayment required to be shown on a return is due to fraud. The amount of the penalty was historically 50 percent of the underpayment.

However, the 1982 tax act (TERFA) bifurcated the penalty into two components, as the 1981 tax act did the negligence penalty. The amount of the penalty became the sum of the historical amount and 50 percent of the interest payable on the portion of the underpayment attributable to fraud. This approach has complicated the resolution of disputes involving the fraud penalty in exactly the same manner that it has complicated the resolution of disputes involving the negligence penalty.

The 1986 tax act (TRA) has further added to the complexity of the fraud penalty. The amount of the penalty is now equal to the sum of 75 percent of the portion of the underpayment which is attributable to fraud and 50 percent of the interest payable on the portion of the underpayment attributable to fraud. Both components of the penalty now demand that each adjustment made by the Commissioner be scrutinized in order to decide whether the underpayment it gives rise to is attributable to fraud.

Presumably, however, the scrutiny each such adjustment receives for purposes of one component of the penalty will suffice for purposes of the other component so that the process is not compounded. However, by relating both components of the fraud penalty to the portion of the underpayment which is attributable to fraud, the 1986 tax act made possible a departure from the historical rule, which had been continued by the 1982 tax act, that the fraud penalty and the negligence penalty are mutually exclusive.

Now if an underpayment of tax is partially attributable to fraud and partially attributable to negligence, the fraud penalty (and therefore its two components) applies to the portion attributable to fraud, and the negligence penalty (and therefore its two components) applies to the portion attributable to negligence. This approach has the potential to turn each and every adjustment made by the Commissioner in a notice of deficiency into a battleground over the triple questions of whether or not a taxpayer was fraudulent, whether or not a taxpayer was negligent, or whether a taxpayer was merely negligent rather than fraudulent. Although this approach is conceptually logical, it unquestionably adds to the burden of litigation.

Overlapping Penalties

In a number of instances Congress has explicitly indicated that two particular penalties are mutually exclusive. Thus, for example, if the fraud penalty is assessed, the delinquency penalty may not also be assessed, at least with respect to the portion of the underpayment which is attributable to fraud. Sec. 6653(d), I.R.C. 1986. Again, if the fraud penalty is assessed, the negligence penalty may not be assessed with respect to the portion of the underpayment which is attributable to fraud. Sec. 6653(a)(2), I.R.C. 1986.

However, there are instances where penalties can apply concurrently. The delinquency and negligence penalties provide an example. Whether other penalty duos can apply concurrently is problematic. For example, if a valuation overstatement is due to fraud, can both the fraud and valuation overstatement penalties be assessed with respect to the same underpayment? Given the proliferation of penalties in recent years, I think the question of concurrent penalties is one that will certainly arise.

Because the touchstone to decision is congressional intent and because the best indication of congressional intent is statutory language, it would be helpful if Congress were to provide specific guidance on this matter by indicating which penalties are mutually exclusive and which may coexist.

Conclusion

Penalty legislation involves a delicate balance between "too much" and "too little." I think few would argue that penalties should be completely eliminated. Certain types of tax behavior must be discouraged -- fraud, for example -- and appropriate penalties undoubtedly do influence behavior.

On the other hand, every penalty carries a certain burden. There is the administrative burden that the Internal Revenue Service must bear in attempting to enforce a penalty. There is the burden that is placed on a court in having to decide yet another matrix of issues in resolving a tax dispute between the Commissioner and a taxpayer. And finally there is the greatest burden of them all -- the burden that is placed on voluntary compliance, the keystone of our self-assessment system, if the laws are perceived to be overly complex, unnecessarily numerous, or simply unfair.

I therefore respectfully suggest that the Congress carefuly weigh these burdens when considering further penalty legislation in order to assure itself that the benefits justify the costs. I would also respectfully request on behalf of the Court, which is, after all, the interpreter of the congressional will, that as clear and thorough an exposition of purpose and intent as possible be set forth in the legislative history so we can comply with the mandate of Congress.

Mr. Chairman, this completes my statement. I will, of course, be happy to answer any questions.

Chairman PICKLE. Thank you, Judge. I particularly appreciate your comments. I think you are in a position to give us a very practical recommendation as we consider this subject.

Now, I want to point out that we have several panels here today, GAO and NTEU, and then we have another panel of practitioners in the field, followed by a panel of four or five former IRS Commissioners. So we have an opportunity to have a lot of important and valuable statements put on the record today.

I think my first question, Commissioner Gibbs, is addressed to you and to this panel as a whole, as well as to all the others.

We are holding these hearings because we think we have a problem and something should be done about it. I think Commissioner Egger attempted to put a study into our 1986 tax bill that would have provided for specific recommendations in this area, but it just wasn't the practical thing to do.

Now, I understand you have a task force appointed, consisting not only of the IRS employees but, I presume, of Treasury and a lot of other organizations.

It seems to me this issue is terribly complex. We all recognize we have got to have penalties. I guess we have had penalties ever since the Garden of Eden, haven't we? This should not be any surprise. And we have to recognize what part penalties play.

You have got a task force now, but it seems to me that we are just saying here is the biggest problem we have got, and yet nobody has done anything much about it.

Mr. Ross testified and gave us very good testimony, but I don't know that he made any specific recommendations and said what we think ought to be done. Judge Sterrett came close, not quite, but he didn't want to tell the Congress what they ought to do.

We reciprocate, Judge, in a sense. We are all holding back.

Now, I don't propose in these hearings that you give us a proposal specifically as to how we ought to handle this. It is much more complex than that. I hope we have more than what some of you have said—that we should evaluate, we should be careful, we should not overlook, we should protect and we should avoid and we should be insistent. These sound pretty and satisfy you lawyers, but I hope as we go along that we try to be as practical as we can. I hope some of the panels that will follow, particularly the former Commissioners, will step up to home plate now and take a good swing at what the problem is and tell us something we ought to do and what we ought to know.

I don't know that this committee is the appointed committee that is going to write a new approach to this problem. We can only do it in context. So I don't want you people in the Government to say you will be glad to cooperate with us. We want you to take the lead and tell us what you think ought to be done, because you are the ones trying to enforce it or who should be enforcing it. I lay that down as a predicate.

Now, Commissioner Gibbs, I am going to get right to the question you mentioned and the question Judge Sterrett proposed as one of his problems, that is, in respect to the area of the no-fault penalty.

What is your position, Commissioner—and, Judge Sterrett, you can comment, too—on the no-fault penalties assessed without regard to the taxpayer's fault or IRS determination of the taxpayer's state of mind or his intent?

It gets to the question of the old section 6661. I am going to submit to you an attachment, Commissioner, at this point, which is an example, where taxpayer A, who is in the 50 percent bracket, makes a charitable contribution and makes a deduction of $600,000. His valuation is later challenged and then he is taken through all the traps. In the year 1969, the example shows that there would be a tax deficiency, negligence penalty, interest on the deficiency that would total an amount due of $218,000. The same situation in tax year 1987 shows the list of penalty would have grown about three times resulting in a total deficiency of $388,000.

[The following was subsequently received:]

APPENDIX A

Taxpayer A, an individual who is in a 50% tax bracket, makes a charitable contribution of property and takes a deduction of $600,000. His valuation of the property is based upon a statement made by a representative of the donee, who was not a qualified appraiser. The Internal Revenue Service determines the correct value of the property to be $400,000. A $160,000 deficiency is assessed, $100,000 of which is due to the overvaluation. Since the tax required to be shown on Taxpayer A's return was $284,000, the understatement due to the overvaluation also qualifies as a substantial understatement.

1. **TAX YEAR 1969:** There was no overvaluation or substantial understatement penalty. Taxpayer, however, was negligent in relying upon the valuation made by the representative of the donee.

   If the taxpayer settles his case after 5 years (on April 15, 1975), the amount due is:

TAX DEFICIENCY	$160,000
NEGLIGENCE PENALTY	8,000
INTEREST ON DEFICIENCY (5 years at 6%)	48,000
INTEREST ON PENALTY (4 1/2 years at 6%)	2,160
	$218,160

2. **TAX YEAR 1987:** Assume the return is timely-filed on April 15, 1988 and the notice of deficiency is issued October 15, 1988. Since Taxpayer A is an individual, and the claimed valuation of the property is more than 150% of the actual value, an overvaluation penalty of 30% of the underpayment due to the overvaluation of the charitable contribution is imposed, that is $30,000. There was no qualified appraisal and the taxpayer failed to make a good faith investigation of the value; consequently, the penalty will not be waived. The additional 5% negligence penalty is now accompanied by a further penalty of 50% of the interest on the

understatement due to negligence. In addition, a substantial understatement penalty of 25% of the underpayment is imposed on the $60,000 of the understatement which is not already penalized as an overvaluation. Moreover, the portion of the deficiency due to the overvaluation, a tax-motivated substantial understatement, is subject to interest at 120% of the adjusted rate.

If the taxpayer settles after 5 years (On April 15, 1993, the amount due is:

TAX DEFICIENCY	$160,000
OVERVALUATION PENALTY	30,000
SUBSTANTIAL UNDERSTATEMENT PENALTY (25% x $60,000)	15,000
NEGLIGENCE PENALTY	8,000
INTEREST ON $100,000 DEFICIENCY DUE TO OVERVALUATION (5 years at 120% of assumed 9% adjusted rate)	71,137
INTEREST ON REMAINING $60,000 TAX DEFICIENCY (5 years at assumed 9% compound rate)	34,074
INTEREST ON $30,000 OVERVALUATION PENALTY (5 years at assumed 9% compound rate)	17,036
INTEREST ON $15,000 SUBSTANTIAL UNDERSTATEMENT PENALTY (5 years at assumed 9% compound rate)	8,519
50% OF THE INTEREST NEGLIGENCE PENALTY INTEREST (Interest on $100,000 for 5 yeas at assumed 9% compound rate = $56,812)	28,406
INTEREST ON PENALTY (4 1/2 years at assumed 9% compound rate)	16,677
	$388,849

Chairman **Pickle**. Now, we are reaching the point where quite often the penalty is much greater than the offense, and a taxpayer who gets notice that he is being charged now 10 times more than what his original fee was—of course, he has reason to complain.

Now, we know those factual situations develop and they are kind of horror stories. What should we do about this section 6661? Should we keep it on the books or judge it, or what is your response?

Mr. **Gibbs**. Mr. Chairman, my response is this. I think we have to be very careful with shorthand titles. I think——

Chairman **Pickle**. Here we go again.

Mr. **Gibbs**. Hear me out.

It seems to me that a, "no-fault" penalty is a lot like a taxpayer bill of rights. Let's get beyond just a title and get down to what the no-fault penalty is about.

What it basically says is this. It says that when taxpayers prepare their returns, at some point they have to be concerned about: do they have authority for the position they are taking, do they believe that the position is correct; if they are not sure, have they disclosed the position that they are taking on the returns. And at some point, if what they do causes a tax deficiency to be determined above a certain amount, it is difficult for me to understand how that is no-fault.

In other words, all the penalty is saying is if you have got authority for the position or if you believe the position is correct or you are going to disclose the position, fine; then if you have a deficiency, the penalty doesn't apply. If you can't show, though, that you didn't originally believe it was correct or you didn't have authority and didn't disclose it in the return and it is such a substantial-sized mistake, then there ought to be a penalty.

That is what we have typically described as a no-fault penalty under section 6661.

It seems to me that the title doesn't quite fit with the facts. So I would say in that regard that it is a penalty that is targeting fault with respect to compliance obligations. I think something like that is necessary because if you don't have it, then to a large extent you are really back to the situation we faced in the 1970s with the audit lottery and so forth, where taxpayers shrug and throw up their hands and say, "Well, the adviser says," "The law was difficult," and so forth, and the penalty or conduct doesn't get penalized.

Chairman **Pickle**. Judge Sterrett, do you want to comment on the same type of thing?

Judge **Sterrett**. Yes, sir.

There is much merit to what the Commissioner says. I think one should be certain that the penalty doesn't apply simply because the taxpayer lost; that is, just because a taxpayer lost, he or she shouldn't automatically therefore incur a penalty.

There ought to be something done, some transgression against the law such as the Commissioner suggests, where the taxpayer clearly did not do his homework and took a position that a reasonable man would have realized, was at best overly aggressive. I think we want to make it clear, in my opinion, that simply because you lose, you do not therefore automatically get a penalty, because there are too many disagreements over what the law says. A taxpayer shouldn't be penalized because he or she comes out on the short side of a legitimate dispute.

Mr. Ross. I agree with what each Commissioner and Judge Sterrett have said, but I think the Commissioner makes an extremely important point in noting that the term "no-fault" really is perhaps misused in connection with the substantial understatement penalty.

What we have done in a sense is change the legal standard of fault for tax purposes from what was historically simply a question of reasonableness, which I think had some liberality, to the requirement that there be some identifiable, substantial authority in support of the taxpayer's position.

I think the failure to have such authority can be seen as fault on the part of the taxpayer.

Chairman Pickle. Well, I would ask a general question of all three of you—particularly you, Commissioner Gibbs, because you are right in the middle of it now.

What are the probable effects of the current system of penalties on taxpayers' morale or compliance?

I recall we were very alarmed a couple of years ago that the taxpayers' compliance—quoting either you or Mr. Egger—had gone to an 80 or 81 percent level, and you viewed with alarm that if this continued to go below 80 percent, our whole system could collapse.

Now, you tell us it is going up to 82 percent. I don't know how you figure that, but I accept your figures. That is getting a little better and I am glad it is.

What is the general sentiment in the field, based on the penalties and complexities, as far as the morale of the people are concerned? What do you think the taxpayers are feeling?

Mr. Gibbs. Generalizations are difficult to make, but I will venture forth.

I will say that at least with respect to certain penalties, certainly along the lines of the penalties that you were describing and some of the comments you heard up here, in many places the attitude is sullen but not quite mutinous yet, to use Herman Hickman's term.

Chairman Pickle. That is not very general. That is a rather specific statement.

Mr. Gibbs. Let me say that with respect to the penalties, I think it is a combination of several things. I think it is a combination of taxpayers basically having to face up to things like large tax shelter deficiencies with penalties and so forth, where they have played the audit lottery and lost. Part of it is a taxpayer problem; part is a practitioner problem; part is that we in the IRS have been very aggressive in the way we have administered the penalties, particularly in the tax shelter area. Part is the proliferation of penalties and the pyramiding of penalties that we have discussed this morning and the cost of penalties and so forth.

I think the reason we are having the hearing this morning is that there is substantial concern about the penalties. I agree with you that we need penalties, but I think we are on the right track in terms of this subcommittee, Internal Revenue Service, the practitioners and others, beginning to do the first thing, and that is identify the problem and get to the root causes and come back with suggested alternatives.

Chairman PICKLE. If the sentiment of the taxpaying public is, in your words, sullen but not yet mutinous, then we must admit that we have a very serious problem and time is important and we must try during this year to do our best to recodify these penalties and our approach.

I am glad to see—and I am going to add parenthetically—the emphasis that you are trying to put on taxpayer services, IRS, and I think——

Mr. GIBBS. A footnote: I would urge that we spend the time to get to the root causes of the problems. I would urge that we not rush to legislation in this area. I would urge that we spend the time to get to the root causes of the problems before we suggest the solutions.

Chairman PICKLE. Commissioner, I don't think this committee has any intention of rushing, but I think we recognize that we have sort of viewed from a distance this problem and we have kind of looked at it and massaged it a little bit.

I think now is the time to get serious with this and see what changes we can make. I hope sometime within the year we can do more than just legally or in a scholarly way look at the problem and see if we can't specifically say what we ought to change.

I have a lot of other questions. Incidentally, a lot of these questions are legal in nature. I recognize that, and we will submit a lot of the questions to you in writing and I want you to respond.

Mr. Schulze, do you have any questions?

Mr. SCHULZE. Yes, Mr. Chairman. Thank you.

I thank the panel for its testimony. It is very interesting.

This is, in my opinion, the initial stage in this process. It is going to be helpful somewhere along the line to have a spreadsheet which shows all of the penalties and their relationship not only to each other but to the violations, and then perhaps some suggestions on how we can bring some order out of chaos so we can simplify related violations or penalties.

So if any of the panel members have suggestions along that line—and, Judge, if you don't want it to be attributed to you, if you want to send us anonymous suggestions—we would love them, to bring simplification.

I agree with the chairman, this is something we are going to have to look at over the next year or maybe more.

One question for the Treasury which might be difficult to answer, or perhaps the answer is obvious. As we go through this, should we attempt to have revenue neutrality?

It seems that I would rather not. I would rather look at this under what should we do that is right, and let the penalties fall where they may, or the dollars fall where they may. But is that something we should keep an eye on? Should we make sure everything we do is revenue neutral?

Mr. ROSS. I am not sure, Mr. Schulze, that that is a necessary constraint in thinking this through. I tend to share your view that we ought to do what makes sense. I think you need to keep in mind that penalties have a revenue significance independent of how much is collected as penalties.

The thesis behind most penalties is that they encourage voluntary compliance. To the extent you affect compliance, you clearly affect revenues. I think this indirect impact on revenue that penalties have is really the more important thing to keep in mind.

Mr. SCHULZE. I suggested that compliance is relatively stable—we have a couple of percentage points here and there—and that this so-called dramatic increase in net penalty revenue has not increased compliance.

Does anybody have any thoughts on that?

As we increase the penalties, are we going to get increased compliance? The statistics don't seem to bear that out.

Are there any thoughts on whether there is a relationship?

Mr. GIBBS. Mr. Schulze, I will venture this comment. I think when you look at some of the early studies that we did and you look at the compliance trend, it had a downward trend in the compliance area, and I think that as you look at the tax acts that have come along, 1981, 1982, 1984 and 1986, I think we are seeing an upward reversal of that and an upward trend, or at least we have reversed the downward trend.

I think the chairman is absolutely right when he says we need penalties. The issue is how we structure the penalties. I think they are important and I do think they have an impact on voluntary compliance.

Judge STERRETT. I might say, from our perspective, that we heard reactions from attorneys in cases we have decided where we have imposed the negligence penalty. It is becoming more of a contested item and the attorneys are noticing that that penalty has been imposed and it may be that their clients have noticed too, and are asking their attorneys, "How come I got a negligence penalty?"

So I think there is no doubt there should be a negligence penalty and it should be imposed in many cases.

Mr. ROSS. Mr. Schulze, I might add I think it is fair to say that a number of the penalties that we would hope would have an effect on compliance are still fairly recent, relatively at least. Their ultimate effect on compliance may remain to be determined.

It seems clear, however, at least from anecdotal evidence that tax practitioners take great care in thinking about the consequences of penalties. I think in that sense it may reflect some greater caution in the advice they give to taxpayers. They may less readily advise the taxpayer to take a very aggressive position.

Mr. SCHULZE. You would say that because we have made the practitioner bear a little more responsibility, he is then performing his task in a more conscientious fashion?

Mr. ROSS. He bears responsibility and I think, as a lawyer, he will advise his client that if such and such is proved to be the case or you can't provide substantial authority for the position you are taking, you will face a penalty.

There is now a greater risk in taking an aggressive position than was previously true.

Judge STERRETT. His advice will be more thoughtful.

Mr. SCHULZE. I guess you wouldn't want to comment on whether the taxpayers now are more honest or dishonest. If we are bringing in more money, you don't conclude that they are more dishonest, do you?

Judge STERRETT. I have no judgment on that.

Mr. ROSS. I wouldn't offer one either.

Mr. SCHULZE. Maybe I shouldn't ask the question. It could lead one to conclude that a greater number of penalties being collected would lead one to say that the taxpayers are growing dishonest. I don't know whether that is a reasonable conclusion, and that is why I asked the question.

Mr. ROSS. I think, as the Commissioner reminds me, the penalties are relatively recent, and to some extent the fact that we have expanded the behavior that is subject to penalty, if that behavior simply wouldn't previously have been affected by the penalty, the level of honesty could have remained the same. The same behavior is subject now to penalty.

Mr. SCHULZE. In recent years the IRS waived almost half the penalties it initially asserted.

Does that mean that the IRS is acting too hastily or they are moving too quickly in asserting penalties, or does that mean that the IRS is putting forth penalties as a bargaining chip, or doesn't it mean either one?

Mr. GIBBS. Mr. Schulze, I think it probably means a variety of things.

In many of our penalty provisions, the penalties are not like tax deficiencies where you give a notice and there is an opportunity for an appeal and that type of thing. Many of the penalties are automatically assessable and then, after they are assessed, the taxpayer has certain rights.

In many instances what we find is this. We have a number of penalties in the code that are—if you miss a deadline from the standpoint of paying on a timely basis or if you don't pay the proper amount of tax, these are computational and relatively routine types of things. When that happens, a penalty is assessed.

Now, there is also a provision that says that, if a taxpayer can show that there was reasonable cause or they exercised due diligence, the penalty can be abated.

What we often find is that, when the notice is sent out, there was something we didn't know about, the information we had crossed the threshold so a penalty was imposed. But under the standard, when the taxpayer gives us the information about why, then we find we are able to abate it.

One of the things I would say in that regard, it seems to me that the relatively high abatements indicate that the system is working with respect to those kinds of penalties.

Mr. SCHULZE. It would also lead one to believe that this is being done by the IRS as a bargaining tool. It is to say that we are going to overstep a little bit so that—then we are willing to negotiate back.

Would it be better if that figure were not so great, where the abatements were lower?

Mr. GIBBS. What I have asked the penalty study group to do is get into this issue of abatements. I think you raise a legitimate point. Why do we have so many abatements of the penalties? We are into that. I agree with the chairman. It is not appropriate simply to talk about these things. Lets have the IRS come back with harder facts.

We found a couple of things that are anecdotal but we will try to quantify them for you. Over time you will have a penalty asserted with a certain tax amount and in a subsequent year you will have a loss that gets carried back. You will actually abate the penalty and refund the amount. You have to be careful when you look at the abatements in terms of what they are for.

We may find also we are at fault with respect to the abatement procedures. We ought to face up to this and do something about it. That is what I will be talking to you about when we get back together.

Chairman PICKLE. Mr. Anthony.

Mr. ANTHONY. Commissioner Gibbs, before I get into my main line of questions I want to give you some good news. My oldest daughter is in the work force. The other day she showed me a tax return from the Treasury Department and said:

> Dad, if anybody complains to you about how complicated it is to fill out their own tax form, tell them they have not sat down and read the form. It is simple, it is easy, and all they have to do is do it.

That may be one in a million, but here is one taxpayer who took the time to sit down and prepare her return. She said she got her refund back 2 weeks before she anticipated, so she is very happy.

Mr. GIBBS. Thank you, Mr. Anthony.

Mr. ANTHONY. I told her I was going to write you a letter. I apologize for not writing something, so I thought I would put on the public record.

When we introduce amendments in the committee, you know that the chairman imposes upon us a responsibility to make them revenue neutral. The purpose of this hearing is to determine whether or not we have a growing problem with relying upon penalties. Penalties have jumped from 64 in 1957 to 150 today. The revenue impact has jumped from $3 to $3.5 billion in 1986 to $9.9 billion in 1987.

If I propose some amendments that would reduce the number of penalties, listening to Judge Sterrett complaining about bifurcating negligence in 1981, fraud in 1982, overlapping others and trying to address the fear, concern and outrage that his clientele has expressed in his courtroom, is the Treasury going to crank up its computer and say to me, Mr. Anthony, your amendment is not revenue neutral and it costs the Treasury money, so you will have to raise money someplace else in order to get any reform in the penalty area?

What is going to be your attitude on this when you crank out that computer model?

Mr. ROSS. Mr. Anthony, that is something we will have to look at in terms of the proposal. I think it would be possible to simplify the penalty structure in a way that would not cost revenue.

Mr. ANTHONY. Why should you even be concerned about the amount of revenue to begin with? Why does it even creep into your vocabulary?

Mr. ROSS. I think there are two issues you have to keep in mind. One is how much we collect from imposing penalties. You can make a case that we should not care about it. The ideal penalty would not raise revenue, because everyone would know about it and it would not have to be assessed. It can have an important revenue consequence, however, through its effect on voluntary compliance. I think it is important and it needs to be part of this committee's considerations, since the reason we have penalties is to encourage compliance.

Mr. ANTHONY. If we have penalties for compliance, you don't have compliance, so you have revenue, at what point does Treasury say to the members of the committee you cannot reform the penalty section of the code because it costs us money and if it costs us money, then you have to raise money someplace else. You know that every amendment offered in our committee has to be revenue neutral and you know there is not one member of the committee that trusts your computer models. Every time we have a good amendment you change the computer every week to make it harder to pass the amendment.

Mr. ROSS. That may be the perception, but let me assure you we don't do business that way. I think, in fact, that most of the revenue estimates you see are produced by the Joint Committee. You know they don't do business that way either.

Mr. ANTHONY. Oversight hearings sought to bring into the tax system people who were not paying taxes on diesel fuel. Farmers are exempt from payment of diesel excise taxes, but we brought them into the tax compliance system. We have been trying to get them out of the taxpaying system because they are exempt. The Joint Committee and Treasury have told us to fix that problem would cost more than the original estimate of the revenue amount of money that was going to be brought in. So it is a real problem. It is an aggravation point on this committee. The chairman can go into all these niceties with Judge Sterrett on all of these cases, but I know when this hearing is over, we will want to do something about it.

I know the first thing that will come from Treasury and the Joint Tax Committee is the computer model. If we cannot get over that first hurdle, we're not going to be able to address the total taxpayers. It is more than a casual comment.

Chairman PICKLE. I want to impose this statement or question to you, Mr. Gibbs, because I know you have to leave, and we are going to excuse you, but in line with the question Mr. Anthony asked about the computer model, I want to say that 90 percent of all penalties assessed during fiscal year 1985 were computer generated. In terms of dollars assessed, 46 percent of all penalties were ultimately abated. That is an interesting statistic to me. Ninety percent of them were computer generated and yet nearly half of them were abated. Is that a correct statement?

Mr. GIBBS. I think we have to be very careful when we talk about computer-generated penalties, because, particularly with the lap top computers we have in the hands of our revenue agents, et cetera, you have a number of different types of computer-generated notices. You have the kind I mentioned that are largely computational in nature, where we generate them, send them out, and the taxpayer writes back and says I agree I would be subject, but I have a reasonable cause why I should not be.

You also have a situation where our examining agents will impose penalties and those penalties, when we complete the revenue agent's report, will actually be generated through a computer program in their lap top computers they now have. That is another type of computer-generated penalty.

We have other types of penalties that come through our computer area because we are increasingly relying on the computer to do the notification with respect to penalties and that type of thing. So that really doesn't surprise me with respect to that kind of computer generation.

Mr. THOMAS. I don't think one was questioning someone using a lap top computer as a replacement for a piece of paper and a pencil. Are you telling me you cannot differentiate between an automatic program, a computer checking a return, the old dualing computers with no humans involved, versus using a computer as an extension of a piece of paper and a pencil?

Mr. GIBBS. The idea of situations where it is simply a computer spitting out things—Mr. Schulze asked me did I think computers made errors or humans. I said humans. When we have computer-generated notices my point is there are persons in the computer process. There are checks and things where the human element comes in.

Mr. THOMAS. I have been to the centers. I know how it works. But with the computer, you have a program that is checked internally and your software shows the error. When you have an agent sitting there putting in the computation on his lap top, he is then manipulating it. You have a simple program. The judgments are made by the person who did the inputting on the lap top. The computer makes the judgments when you have the initial people making inputs in the match-in.

Mr. GIBBS. But we have gotten into humans making decisions about abatements—46 percent. Once the taxpayer says "I had reasonable cause," there is a human who says "you are right," and we will abate the penalty.

Mr. Anthony, I am about 15 minutes late and with your permission, I would like to thank you for having me today and to tell you we will be back with something more concrete in the way of suggestions. the way of suggestions.

I think you are right, what we need at this point are suggestions.

Mr. ANTHONY. To repeat my daughter's suggestion. She said all you had to do is sit there and read the form.

Mr. GIBBS. Thank you.

Mr. Thomas, I will come back and give you a response to the matter you raised.

[The following was subsequently received:]

Additional Information in Response to Mr. Thomas's Question on Computer Generation of Penalties

What IRS means by "computer generated" is that the computation of the penalty and the preparation of the billing were performed within the computer's program based on information transcribed by a person from the return or from other sources such as deposit information.

For example, penalties, such as the failure to pay estimated tax penalty, are computer generated based upon information from the return, such as tax liability and information in the data base, such as when estimated tax payments were made. Also in the data base is the amount of the previous year's tax, which permits the computer to calculate one of the four statutory exceptions to the estimated tax penalty before generating a penalty notice. If the taxpayer files a Form 2210, Underpayment of Estimated Tax by Individuals and Fiduciaries, with the return, the additional information provided on that form is entered into the data base by the tax examiner and is taken into account in the computer's calculation of the penalty. If a penalty is warranted, the computer prepares the notice which advises the taxpayer of the amount of penalty that is due.

Throughout the assessment process there is a human involved in the entry of the data into the computer record, and therefore, an opportunity for the human to effect the assertion or non-assertion of the penalty. Additionally, there is opportunity for review of notices being sent to taxpayers. However, once the information is entered into the computer, verification that the penalty notice is correct is done on a sample basis only.

Since the internal logic of the program is carefully tested before being put into use, the most common errors in penalty notices generated by the computer are human errors, including the failure to enter data correctly or completely. There are a number of controls to ensure quality of data transcription and account verification within the system designed to catch these errors, especially errors of a systemic nature, and error rates are carefully monitored. However, errors can and do occur which result in incorrect penalty notices. We capture data on taxpayer responses to notices in an effort to identify problems associated with the processing of tax returns or data entry.

It should be noted that any penalty which may be asserted within the scope of a computer program may also be asserted by a human examiner. Further, abatements may also be made by human intervention, or, in limited circumstances, by computer. An example of a situation where the computer programming results in an abatement of a penalty is the failure to file penalty in section 6651(a). The penalty, by statute, is a percentage of the amount of tax due. If the tax due were, say, $1000, and the return were filed five months late, the penalty would be $250. Suppose that two years later the taxpayer has a net operating loss which can properly be carried back to the penalty year, thereby reducing the tax for that year to $500. The tax being reduced, the computer will automatically (and properly) reduce the penalty to $125, based solely on the reduction in the amount of tax due, and that reduction would show up as an abatement.

Mr. ANTHONY. Judge Sterrett, I understand you are the Chief Judge?

Judge STERRETT. Yes, sir.

Mr. THOMAS. How long have you been there?

Judge STERRETT. Three years.

Mr. THOMAS. You have been on the court how long?

Judge STERRETT. Twenty years.

Mr. THOMAS. In that 20 years and in that 3 years, have you seen more or less backlog in tax cases? Is it smaller, larger, or static?

Judge STERRETT. I am happy you asked the question because it is dropping off. It reached a peak of 84,000 cases in October of 1986. It is now down to about 70,000. It is off about 17 percent.

Chairman PICKLE. What number is that?

Judge STERRETT. From 84,000 to slightly below 70,000. It was up to 84,000 and that is why we were so pleased it is going back down.

Mr. ANTHONY. What would be our comment if the Congress passed legislation that gave the Commissioner of Internal Revenue permission to go in and negate on a percentage basis, 75 percent of all pending cases without regard to fault? In other words, would offer the adversaries the opportunity to come in and just settle without regard to fault for *x* number percent on the case? What would be your attitude on that?

Judge STERRETT. It would not be my place to comment on whether or not that would be a good policy. I suppose if that were put into effect, the result would be no doubt a lot of settlements. Whether it is settlements on a good policy basis is not for me to say.

Mr. ANTHONY. So you don't have an opinion whether or not it would improve?

Judge STERRETT. It would drop our inventory. I don't doubt that.

Mr. ANTHONY. Would it help you in terms of being able to administer the most important cases, where there is fraud, abuse, so you could get those people penalized so there is a better compliance with it?

Judge STERRETT. The remarkable thing about the inventory at each point in time, the turnaround time so to speak, in which we turn around a case is remarkably the same. I can't explain how we do it that way, but whether we have an inventory of 50,000 cases or 70,000, they go through the process in about the same time. It would drop the numbers but I don't think it would have a dramatic effect on how quickly the turnaround time is.

Mr. ANTHONY. Based on your testimony with the Congress bifurcating negligence in 1981, fraud in 1982 and having concurrent and overlapping penalties, is it your bottom line that you think there is an area of concern and an area we need to go back to and visit, and revise?

Judge STERRETT. It is our responsibility to advise Congress about what we see as the consequences of that legislation in court. If you are going to have that sort of overlapping penalties and if you are going to have the fraud penalty applying to only certain dollars, and the negligence penalty applying to only certain dollars, it is going to take longer to try a case, because the attorney will go dollar for dollar in that case, identifying them as fraudulent or negligent. I think it is our responsibility to advise you that that is what will happen, sir.

Mr. ANTHONY. Thank you very much.

Chairman PICKLE. Thank you.

Mr. Rangel, do you have any questions?

Mr. RANGEL. Is there a training school for the directors of the local agencies as to how they should treat their irritated clients?

Mr. BRENNAN. In the districts, Mr. Rangel, we do have. You say irritated?

Mr. RANGEL. I am talking about the directors and their staffs, are they trained in how to handle the taxpayers?

Mr. BRENNAN. Yes, sir. There is a person on the director's staff known as the problem resolution officer, who is trained to deal with problems when that system does not work.

Mr. RANGEL. The directors, are they trained? Do they have regular workshops as to how to treat taxpayers?

Mr. BRENNAN. Yes. We bring the directors in at least once each year to Washington, in the fall—October. We just had our last session. There is as part of that, training put on to sensitize everyone——

Mr. RANGEL. I hope you share that with me because I can't tell you how difficult it has been for me to deal with some of the directors and how easy it has been to deal with the Commissioner's office. It has never been a problem in asking for any rebates or removal of penalties, it has always been a question of time or the taxpayer having the money, or the taxpayer trying to settle where you have become involved personally.

I don't know whether this was just a local thing. I have talked with members who have had similar problems. I would want to assess the Service in seeing whether we can work out something together if it is money that you need for training. I did not want the IRS to be any different than any other creditor, and that is courteous and understanding.

So if you could share with me the training that is required on a periodic basis, it would be helpful.

Mr. BRENNAN. We will do that.

[The following was subsequently received:]

ADDITIONAL INFORMATION IN RESPONSE TO MR. RANGEL'S QUESTION ON TRAINING FOR DISTRICT DIRECTORS IN TAXPAYER RELATIONS

The district directors are generally chosen from our experienced executives who have previously completed our executive development program. Upon selection to this program, new executives spend 6 months in training. Since 1986, this training has included customer service and quality of service topics. Before entering the program, most participants would already have had taxpayer relations training along with their technical training in tax law.

Annually, our directors and other service executives come into Washington for our Joint Conference, a combination of discussion and continuing professional education. Each conference includes segments focused on customer relations. For example, last October we hired a private industry speaker to talk about quality and customer service in industry and in IRS. The conference also showcased a quality improvement project from our San Francisco District which featured "the one-service concept" and is improving our taxpayer relations in that office.

With our renewed emphasis on quality and customer service, all IRS executives received 2 days of training from the Juran Institute on quality improvement for service industries. More recently, all directors have installed a quality improvement

process in their districts and have received 2 additional days of training with their quality councils.

Chairman PICKLE. Thank you, Mr. Rangel.

I want to add in that respect, that bringing the IRS ombudsman to Washington once a year for training would not be enough?

Mr. BRENNAN. We were talking about our district directors. Our problem resolution officers will have more frequent meetings.

Chairman PICKLE. I will make this observation to you, and the public generally, I have said earlier that I think Commissioner Gibbs is putting the right emphasis on taxpayer services, more so than in any other year I have seen. The efforts must be doubled and tripled. If I am any example of complaints received about IRS services, I can tell you over a third of our complaints are about how they have been treated and how they have a just cause that has not been heard.

My district director, Mr. Booth, is here today, and I appreciate your cooperation. Every director in the country ought to be a part of a specific group to meet with the public and be aggressive in giving services. I think we have to do more than just passing judgment and dropping a hammer. I want to know more about what you are doing in the field. I hope all the districts are doing it in the country.

Mr. BRENNAN. It is nationwide.

Mr. THOMAS. I would like to associate myself with some of the remarks that the gentleman from Arkansas just made.

Mr. ANTHONY. Which ones?

Mr. THOMAS. The idea of penalties in the revenue generation, the whole problem of generating accurate figures that are agreed upon. It is a difficult area, but it is very frustrating to us with no partisanship intended, to get answers on their face that are ridiculous and people are trying to make—it is very difficult then to make decisions.

My district is very close to the Fresno Center and we have a good working relationship with the Fresno Center. Whenever we deal with people, they have a very good attitude. Unfortunately, we have to deal with them all too frequently. I guess it is the same point that the gentleman from Texas made, my job in getting reelected is made so much easier by you people. It is you and Social Security that gives me primary contacts with people in trouble.

You cannot imagine the fear persons get in their hearts when they get an IRS problem. They call the case worker and 1 day later, all the problems are removed, and we have intervened in a system where they were totally awash and had no hope of straightening it out. About 50 percent of the penalties are abated. I am going to have to clean that percentage up, because I will have to go work harder.

We know who to call, we know how to get it checked. It is kind of sad that that is the way the system operates. That is what we want to talk about for a minute. In terms of the penalties that you have, we have a myriad of penalties. On a taxpayer's challenge procedure, I don't see them at the 11th hour when they have no other opportunities and they are thinking about going to Tax Court.

We put a call in and it is all resolved. I can't figure out why that could not be done by the taxpayers themselves. Are the appeals or the challenges in a narrow category, or do you have as many avenues for appeals as you do penalties?

Mr. BRENNAN. Basically when the taxpayers receive their letters and either call in or write in, it can be handled at the one place—at the Service Center. Based on the new evidence submitted, the penalties are abated right there.

Mr. THOMAS. Is it always true or generally true that you have to pay first and then we will sit down and talk about how to resolve your problem?

Mr. BRENNAN. I would say generally it is not true that you have to pay first.

Mr. THOMAS. I would prefer an orderly structure as we go through this. We have a penalties problem but I would like to see the challenges and appeals procedures and a matrix association of whether you have to pay first to challenge in terms of what you do. You can leave us out of it. But what are their options in working with you and when it kicks over to the Tax Court? I think that end has grown as quickly as the penalties end has. I don't know if there is a streamlining on the challenge side.

If we are waiving as many penalties or perhaps getting corrections of what appear to be penalties as we are, if you only do 10 percent, then your opportunity for inconsistency is less. If you are doing 50 percent on a waiver basis, then you have a chance for people to follow policies that perhaps are are not as consistent as we would like.

What kind of checks internally do you carry out to determine if the waiving of penalties is done on a consistent basis? Not just in an area but between areas. Do you have checks on that process?

[The following was subsequently received:]

ADDITIONAL INFORMATION IN RESPONSE TO MR. THOMAS' QUESTION ON APPEALING PENALTIES

There are a number of avenues of appeal for penalties, both formal and informal. The method of appeal depends upon the type of penalty, whether it is proposed or already assessed, and which function of the Service has proposed or assessed the penalty. When a penalty has been assessed, an amount has been charged to a person's account, and it is now due and owing.

The first step in challenging any penalty is to contact the person or office who initiated it. When a penalty is proposed or assessed, the taxpayer receives an explanation and instructions on what to do if the taxpayer does not agree. At this point, providing additional information to the initiating office may result in a proposed penalty being dropped as an issue and an assessed penalty being abated so that it is no longer due from the taxpayer. A taxpayer may also want to discuss the penalty with the initiating employee's manager. As an additional safeguard, each office making penalty determinations has a system to review the decisions made.

If a taxpayer is unsuccessful at this point and still believes the penalty is not justified, the taxpayer may appeal administratively. An appeals officer who is independent of the initiating office will consider the case.

Some penalties, such as those proposed by Examination in the course of audit, may be appealed along with the proposed tax deficiency prior to assessment and prior to payment. Penalties for negligence, fraud, or substantial understatement are examples of this kind of penalty. If the appeals officer sustains the penalty, the taxpayer may petition the U.S. Tax Court without payment.

A similar type of preassessment administrative appeal is also available on a few penalties such as the 100 percent penalty under IRC 6672 and the return preparer conduct penalties under IRC 6694. However, if the taxpayer does not request an administrative appeal before assessment on these types of cases, the taxpayer also has a chance to appeal after assessment. These penalties may also be appealed on special claims for refund. The taxpayer pays a specified portion of the penalty amount and files a claim. If this special refund claim is denied by IRS, the taxpayer may file suit in the appropriate U.S. District Court or in some cases, the U.S. Claims Court. In these special cases, the full penalty amount does not need to be paid before going to court.

Most penalties are assessed by the service centers. Taxpayers may write the service center to request reconsideration of a penalty based on the circumstances involved. These penalties may also be appealed after assessment if the service center does not accept the taxpayer's explanation. Payment does not have to be made prior to appealing the penalty. During the appeal, IRS may or may not send balance due notices or take collection action on an assessed penalty. Taking collection action during an appeal depends on the particular type of penalty, dollar amount, or the extent to which the Collection function is already involved in the case. If the appeals officr sustains these assessed penalties, the taxpayer must pay them in full before pursuing a judicial appeal. After full payment, the taxpayer may file a claim for refund. If the claim is denied by IRS, the taxpayer may file a suit with the appropriate U.S. District Court or the U.S. Claims Court.

It is important to note that, even if the taxpayer does not request formal administrative appeals consideration the taxpayer could still informally "appeal" later and request abatement of the penalty from a revenue officer or other Collection employee who has responsibility for the taxpayer's case. In appropriate situations, a Problem Resolution Program (PRP) employee could also abate penalties. Thus, there are several informal opportunities to have penalties abated as well as various avenues to a formal administrative appeal.

Mr. Brennan. In terms of the figures that have been talked about, the so-called abatement rate being around 50 percent, that is true for the dollars assessed. For the volume assessed, the abatement rate is much lower than that. It runs in the neighborhood of 15 to 20 percent.

Also, I would mention that the volume of penalties, the numbers that have been assessed over the past 4 or 5 years has not really grown dramatically.

In terms of your questions on reviews, yes, there is what we call a notice reviews program. As you mentioned, we do calculations and many things by computers, but before those notices go out, the notices are pulled and reviewed to be sure a quality product is going out. There are a number of operational reviews done in each Service Center, and by our regional offices and the National Office.

Mr. Thomas. How low does the decision go in terms of yes or no? Is it below a director?

Mr. Brennan. Yes.

Mr. Thomas. How low does it go?

Mr. Brennan. It is basically at the tax examiner level.

Mr. Thomas. How many tax examiners do you have?

Mr. Brennan. Hundreds in a service center.

Mr. Thomas. So we are talking about tens of thousands of people who can say yes or no?

Mr. Brennan. There are hundreds of people and if you do Nationwide, there are thousands of people who would be involved in this.

Mr. Thomas. That have the final yes or no, but not just involved?

Mr. Brennan. Right.

Mr. Thomas. People who can say yes or no in terms of a penalty, that is what I am looking for. I am looking for the number of people who can say yes or no. What is the lowest level that you can get a definitive decision and how many people?

Mr. Brennan. It is at the tax examiner level.

Mr. THOMAS. So it is thousands of people. Is the goal of the IRS to lower that or have you thought of making it higher? That is where you run into the consistency problem. People look at it from different perspectives and they have different emotional levels and they respond to different pitches.

Mr. BRENNAN. I think that is true. We are not looking to move it lower. We are looking for two things. To make sure that our people are consistently and well trained.

And second, we are looking to develop—and we are working on it right now—artificial intelligence programs that we could use to insure consistency. I believe down the road that we may raise the level.

Mr. THOMAS. The reason I said pitches is if you are telling me that the number we are dealing with is only a 15- to 20-percent kickback but the volume is a 50-percent kickback then maybe it is additional information or it was not presented in a form to allow you to see the computation. Therefore, the discretionary factor is even more critical in terms of how you make these decisions.

I am willing to go with you on this journey, Mr. Chairman, but it will make the members' jobs harder when you remove the easy fixes in dealing with IRS problems, which appear to be IRS problems, but in fact are not.

Chairman PICKLE. I suppose there is no disagreement that 150 tax penalties is too many. There must be an admission that it is growing larger. It has doubled within the last 10 years. I assume there is no argument about the fact that we ought to change the system. Is anybody in disagreement with that?

I would like to say then that the IRS has a task force at work on this question. So has the American Bar Association, and so has the CPA organization. I understand that all of them hope to have some kind of a general analysis and recommendation by late summer or early fall.

I am going to then ask IRS if you would submit, as a goal at least, to this committee, some specific recommendations, presumably in consonance with the Treasury Department, about how we might make the changes. If we are going to have these analyses in by late summer, then we ought to expect something to us as a committee recommendation by this fall. I hope you keep that in mind as a goal and pass that on to Commissioner Gibbs.

We have many witnesses today, so we will have to submit our questions in writing, since time is short. Thank you very much for your attendance here this morning.

The Chair would ask Johnny Finch, Deputy Director, General Government Division, U.S. General Accounting Office. I understand you have Lynda Willis, Group Director, with you this morning?

STATEMENT OF JOHNNY C. FINCH, DEPUTY DIRECTOR, GENERAL GOVERNMENT DIVISION, U.S. GENERAL ACCOUNTING OFFICE, ACCOMPANIED BY LYNDA WILLIS, GROUP DIRECTOR, TAX POLICY AND TAX ADMINISTRATION AUDIT GROUP

Mr. FINCH. Thank you, Mr. Chairman.

Lynda Willis is with me, sir. She is the group director in our Tax Policy and Tax Administration Audit Group, who will be responsible for managing the work in the penalties area we will be doing for your subcommittee in the coming months.

Chairman PICKLE. We are pleased to have both of you with us.

Mr. FINCH. I would like to submit my statement for the record and with your permission, I will summarize.

We are pleased to be here today to assist the subcommittee in its review of the civil penalty provisions in the Internal Revenue Code. My statement today covers four points:

First, the need for a comprehensive review of civil penalties and some of the objectives for such a review.

Second, the methodology of the IRS Commissioner's Study of Civil Penalties.

Third, what we know about problems in IRS' administration of civil penalties.

And fourth, the circumstances in which computers generate penalties.

As the tax system has become more complex, so have the accompanying penalties. Given this and the sweeping impact of the Tax Reform Act of 1986, this subcommittee, other congressional committees, and the Commissioner have expressed concerns over the civil penalty provisions of our tax laws. We share these concerns and support the notion that a comprehensive review of those provisions is in order.

The first step should be to identify and understand the problems with the existing system. To this end, the Commissioner has launched a study of the civil sanctions available to IRS. At your request, we have begun to review the methodology being used in IRS' study.

Our preliminary observations are that it currently draws heavily on expert opinion and advice from IRS management and outside organizations, and that its schedule is ambitious. While expert opinions and advice are valuable in identifying problems and developing recommendations for improvement, the IRS study does not presently provide for sampling of taxpayer returns to validate the experts' concerns and opinions, or to empirically determine how well IRS is administering the various penalties.

Without this information it will be difficult to quantify the nature and extent of the problems or to identify and correct their cause. Our work will fill part of the gap by providing the empirical evidence necessary to evaluate the effectiveness of IRS' administration of a limited number of specific penalties.

IRS' administration of civil penalties is a key issue. We have not yet done sufficient work to be in a position to comment conclusively on IRS' overall effectiveness in administering civil penalties. However, our work related to several specific penalties and recent reports by the IRS Internal Audit Staff identify potential problems that should be considered in any comprehensive review.

These problems include instances where IRS did not assess certain penalties when they were warranted, abated penalties when they were not required to do so, made computational errors, and did not assess certain penalties consistently among IRS district offices.

For example, a 1986 IRS Internal Audit report concludes that IRS overlooked millions of dollars in penalties that should have been assessed against employers who claimed fictitious tax deposits on their employment tax returns. Of the accounts with fictitious deposits that Internal Audit identified, none were assessed the penalty. Internal Audit staff projected that, on a nationwide basis, IRS did not assess $437 million in such penalties in 1986.

In an ongoing tax shelter promoter study, we found that IRS made several computation and oversight errors when assessing abusive tax shelter promoter penalties. IRS made 20 such errors resulting in about $4 million in penalty underassessments in 9 of the 29 total cases at 3 selected district offices.

Similarly, inconsistent enforcement of penalties by IRS district offices has also been identified as a problem. For example, we found in our tax shelter study that one district decided not to administer the tax shelter late registration or nonfiling penalty because of the belief that it was too new. The other two districts were assessing late filing penalties but were using a late filing grace period greater than that established by the national office.

You asked us to determine the extent to which IRS uses computers to assess penalties and, if by doing so, IRS assesses a significant number of inaccurate penalties which are ultimately abated or erroneously paid by taxpayers. We found that IRS does not have data readily available to identify the number of penalty assessments which are computer generated. Neither is information available to abatements of erroneous payments.

Theoretically, computer generated penalties should be more consistently assessed than manually generated penalties. Penalties assessed by the computer involve conditions which are specific, well defined, and do not require the exercise of subjective judgment.

In summary we support the need for a comprehensive review of the civil penalty structure. We also believe that now is a good time to begin.

Several issues would need to be addressed in a truly comprehensive review. These include the purpose, need for, and effectiveness of each penalty provision, and the equity and efficiency of IRS' civil penalty administration. Past work by GAO, IRS, and others provide a starting point. But all the information necessary to respond to these issues is not presently available.

The Commissioner's civil penalties study is an important step in developing the information needed. However, undertaking a review of almost 150 penalty provisions and their interrelationships is a massive task. In our view, the Commissioner's study is an ambitious undertaking for the targeted time frames.

We will continue to monitor the evaluation of the study and will keep both IRS and the subcommittee advised of our thoughts.

That concludes my statement, Mr. Chairman. I would be happy to respond to any questions the subcommittee may have.

Thank you.

[The statement of Mr. Finch follows:]

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Comprehensive Review of Civil Penalties Needed

Statement of
Johnny C. Finch, Deputy Director
General Government Division

Before the
Subcommittee on Oversight
Committee on Ways and Means
House of Representatives

GAO/T-GGD-88-24

CIVIL PENALTIES

SUMMARY OF STATEMENT
JOHNNY C. FINCH
DEPUTY DIRECTOR
GENERAL ACCOUNTING OFFICE

Congress has enacted nearly 150 civil penalties in the Internal Revenue Code (Code) to encourage compliance with the tax laws. In many instances, penalties were enacted or modified on an ad hoc basis without full consideration being given to the overall civil penalty structure. Given this and the sweeping impact of the Tax Reform Act of 1986, this Subcommittee, other Congressional committees, and the Commissioner have expressed concerns over the civil penalty provisions of our tax laws. We share these concerns and support the notion that a comprehensive review of those provisions is in order.

The IRS Commissioner has initiated a comprehensive study of civil penalties. We think the study timetable is ambitious. The methodology of the study is evolving, but at present it does not appear to encompass the empirical analysis we believe necessary to fully address the issues. Our work will help fill part of the gap by providing the empirical evidence necessary to evaluate the effectiveness of IRS' administration of a limited number of specific penalties.

We were asked to determine if by using computers, IRS assesses a significant number of inaccurate penalties which are ultimately abated or erroneously paid by the taxpayer. We found that IRS does not have readily available data to identify the number of computer-generated penalty assessments or the percentage of those assessments abated or erroneously paid. Theoretically, computer-generated penalties should be assessed in a more consistent fashion than manually-generated penalties. This is because penalties assessed by the computer involve conditions which are specific, well defined, and do not require the exercise of subjective judgment.

We have not yet done sufficient work to be in a position to comment conclusively on IRS' overall effectiveness in administering civil penalties. However, our work related to several specific penalties and recent reports by the IRS Internal Audit staff identify potential problems that should be considered in any comprehensive review. These problems include instances where IRS did not assess certain penalties when they were warranted, abated penalties when they were not required to do so, made computational errors, and were not consistent in assessment policies among IRS offices.

Mr. Chairman and Members of the Subcommittee:

We are pleased to be here today to assist the Subcommittee in its review of the civil penalty provisions in the Internal Revenue Code (Code). My statement today covers four points:

- -- first, we endorse the need for a comprehensive review of civil penalties and discuss some of the objectives for such a review,
- -- second, we comment on the evolving methodology of the IRS Commissioner's Study of Civil Penalties,
- -- third, we describe the circumstances in which computers generate penalties, and
- -- fourth, we summarize what we know about problems in IRS' administration of civil penalties.

COMPREHENSIVE REVIEW OF CIVIL PENALTIES NEEDED

The success of our tax system depends on voluntary taxpayer compliance. To encourage compliance and to punish noncompliance, Congress has enacted numerous civil penalties. In the past 70 years, nearly 150 civil penalties have been placed in the Code. In many instances, penalties were enacted or modified on an ad hoc basis without full consideration being given to the overall structure of civil penalties.

With greater use of penalties, more questions have been raised as to the role civil penalties should play in our tax system. In fiscal year 1987, IRS assessed almost 27 million penalties, totaling over $14 billion. This was more than a 100 percent increase over the total dollar amount of penalties assessed in 1986. IRS' administration of civil penalties frequently results in criticism. The criticisms have focused primarily on IRS' (1) failure to fully utilize all penalty provisions, (2) assessment of many penalties which are subsequently abated, and (3) inconsistent assessment of penalties by different IRS offices and functions.

Our tax system and our society are different than they were in the past. We now face a tax gap of over $80 billion, large federal budget deficits, and what IRS describes as growing animosity between the taxpayer and the tax administrator. Given this, the ad hoc approach with which many of the present penalties were enacted, and the sweeping impact of the Tax Reform Act of 1986, this Subcommittee, other congressional committees, and the Commissioner have expressed concerns over the current structure of the civil penalty provisions of our tax laws. We share these concerns and support the notion that a comprehensive review of those provisions is in order.

Objectives of Planned Studies

If civil penalties are to be a major enforcement tool in our tax system, we need to assure ourselves that they are well thought-out, credible, understood by the nation's taxpayers and tax practitioners, can be administered consistently and effectively by IRS, and do in fact achieve their purposes. Whether the present system of penalties accomplishes these goals is not known.

The first step in examining civil penalties should be to identify and understand the problems with the existing system. To this end, the Commissioner has launched a study of the civil sanctions available to IRS. The study proposes to review the value of these sanctions to the tax system, identify problems arising from their administration, and make recommendations for improvement.

Similarly, at the request of this Subcommittee and the Senate Finance Committee's Subcommittee on Private Retirement Plans and Oversight of IRS, we are beginning work which will focus on IRS efforts to fairly and consistently administer civil penalties. We will analyze the quality of the information used by IRS in assessing and abating certain penalties, determine if IRS is assessing and abating the penalties in a fair and consistent fashion, and if appropriate, comment on how the administration of the penalties could be improved.

Chairman Pryor has requested that we examine civil penalties for substantial understatement of tax liabilities [section 6661], civil negligence and fraud [section 6653 (a) and (b)], and understatement by a return preparer [section 6694 (a) and (b)]. We are presently discussing with Subcommittee staff the penalties and scope of work that will be involved in responding to your request.

Our work and that of the Commissioner's study group will provide much of the information needed to consider the adequacy of the civil penalty structure and will establish a better foundation for congressional deliberation and debate.

COMMISSIONER'S STUDY OF CIVIL PENALTIES STILL EVOLVING

At the request of this Subcommittee and the Senate Subcommittee on Private Retirement Plans and Oversight of IRS, we have begun to review the methodology being used in IRS' study. Our analysis to date has been limited to the study prospectus. Our preliminary observations are that the methodology (1) is still evolving, (2) currently draws heavily on expert opinion and advice from IRS management and outside organizations, and (3) will attempt to aggregate existing IRS statistics in a fashion that will enhance their usefulness in analyzing civil penalties.

While expert opinions and advice are valuable in identifying problems and developing recommendations for improvement, the IRS study does not presently provide for any scientific sampling of taxpayer returns and accounts to validate the experts' concerns and opinions, or to empirically determine how well IRS is administering the various penalties. Without this information it will be difficult to quantify the nature and extent of the problems or to identify and correct their cause.

The IRS study calls for the assembly of existing data on each penalty and for the identification of gaps in this information. It is our experience that IRS has not historically aggregated the penalty data it collects in such a fashion to make it useful in reviewing all of the various issues and concerns associated with the imposition of civil penalties against taxpayers. For example, IRS does not routinely aggregate penalties by Code section.

Further, it is unclear whether IRS statistics capture all of the penalties assessed and abated. For example, the most dramatic increase from fiscal year 1986 to 1987 in penalty assessments was in the non-return category. The non-return category includes penalties assessed in situations where the noncompliance is not associated with the filing of a return by the taxpayer, such as tax shelter promoter penalties and preparer penalties. Assessments in this category rose from $268 million in 1986 to about $6.0 billion in 1987. In terms of the number of penalties assessed, the non-return category increased from about 106,000 in 1986 to about 478,000 in 1987. IRS attributes most of this increase to penalties which had previously not been captured in IRS statistics.

The quality of IRS' statistical data also needs to be considered. An October 1987 IRS Internal Audit report concluded that penalty management information reports may contain misleading and inflated figures on assessments, abatements, and abatement rates. Internal Audit found that in 1986 about $340 million in Failure To Deposit employment tax penalties had been erroneously assessed and subsequently abated. Since IRS detected and abated over 90 percent of these erroneous penalties before notifying taxpayers, including such figures in IRS statistics produced misleading results.

The Commissioner's study prospectus calls for the identification of data needed to complete the study by April 1988. The points we have made should be included in this needs assessment.

COMPUTERS USED TO GENERATE NONSUBJECTIVE PENALTIES

You asked us to determine the extent to which IRS uses computers to assess penalties and, if by using computers, IRS assesses a significant number of inaccurate penalties which are ultimately abated or erroneously paid by taxpayers. We found that IRS does not have data readily available to identify the number of penalty assessments which are computer generated. Neither is information available on abatements or erroneous payments.

IRS began using computers for tax administration purposes in the early 1960s. Since that time, IRS has included penalty assessments in its use of computers. Presently, the majority of penalties assessed by the 10 IRS service centers are computer generated. These penalties typically result when the taxpayer fails to take a required action by a specific date, such as failure to file a return on time.

While returns and related documents are being processed, the computer will identify situations in which the required conditions for a specific penalty are present. For example, when a service center receives a tax return with an outstanding tax liability after the due date, the computer will automatically assess the failure to file penalty, unless the taxpayer's account indicates that an extension was previously granted. The computer would also assess a failure to pay penalty if there is any outstanding tax liability.

After a penalty is assessed, the computer prepares a notice that is mailed to the taxpayer stating a reason for the penalty. If the taxpayer disagrees with the assessment, the taxpayer can present evidence requesting an abatement.

Theoretically, computer generated penalties should be more consistently assessed than manually-generated penalties. Penalties assessed by the computer involve conditions which are specific, well-defined, and do not require the exercise of subjective judgement. The computer uses the information provided or lack thereof to determine that a penalty is or is not appropriate.

In contrast, penalties are assessed manually when the complexity of the issue requires the use of subjective judgement. These penalties include negligence, fraud, or promoting abusive tax shelters. The accuracy of manually generated penalties can be affected by many factors, including IRS employee judgement, training, clarity of guidance, and district policy.

Conversely, computer-generated penalty inaccuracies generally stem from instances where the data provided the computer is inaccurate or incomplete, or where there is an error in the computer program. In such instances, computer-generated penalties have the potential to affect many more taxpayers than those that are manually generated. For example, in February 1988 the IRS, using inaccurate information provided by the Social Security Administration, generated thousands of erroneous penalty notices assessing penalties against employers for failing to file W-2 information on magnetic media. While one service center discovered the inaccuracy before notifying the employers, other service centers did not and mailed out inaccurate notices.

IRS reviews a selected sample of both computer-generated and manually generated penalty notices before they are sent to taxpayers. The review is performed to ensure that the notices are technically as well as mathematically correct.

PROBLEMS IDENTIFIED IN IRS ADMINISTRATION OF PENALTIES

We have not done sufficient work at this time to be in a position to comment on IRS' effectiveness or on the difficulties it encounters in administering an increasingly complex system of civil penalties. However, we believe our work related to several specific penalties and recent reports by the IRS Internal Audit staff identify some types of problems which should be considered in a comprehensive review of the civil penalty structure. These problems include instances where penalties were not assessed when warranted, where penalties were not computed accurately, and where IRS District Office policies varied on the assessment of certain penalties.

Penalties not assessed when warranted

Three IRS Internal Audit and two GAO studies have shown that IRS did not assess penalties in all cases where they were warranted. For example, a 1987 IRS Internal Audit report concluded that in 1986 IRS overlooked millions of dollars in penalties that should have been assessed against employers who claimed fictitious tax deposits on their employment tax returns. Internal Audit's sample of 426 taxpayer accounts contained 217 accounts with fictitious tax deposits. Of the accounts with fictitious deposits none were assessed the penalty. Internal Audit staff projected that, on a nationwide basis, IRS did not assess $437 million in such penalties in 1986.

As a second example, our study of IRS' administration of the penalty for promoting abusive tax shelters at three selected district offices shows that IRS should have but did not assess all applicable penalties in 39 percent of the 28 total cases the three offices closed between September 1982 and July 1986. Penalties were not assessed because district officials did not know that multiple acts of organizing, promoting, and selling abusive tax shelters by the same person are each subject to penalty. National Office guidance did not illustrate how to treat multiple acts.

Penalties Not Computed Accurately

Computation and other types of errors have also been documented by GAO and IRS internal auditors. IRS' Internal Audit reported in 1987 that computation errors were found in 27 percent of 75 selected examination cases. These cases covered examinations of 1983 and 1984 individual income tax returns in 5 districts and one service center. The calculation errors ranged from an overassessment of $1,386 to an underassessment of $259.

In our tax shelter promoter study, we found that IRS made several computation and oversight errors when assessing abusive tax shelter promoter penalties. IRS made 20 such errors resulting in about $4.0 million in penalty underassessments in 31 percent of the 29 total cases at 3 selected district offices.

Inconsistent District Office enforcement policies

Inconsistent enforcement of penalties by IRS District Offices has also been identified as a problem. For example, in a 1983 GAO report on return preparer penalties, we found that each IRS district determined its own level of activity for assessing the penalty against preparers who endorsed or negotiated taxpayers' refund checks. One district office, which took a more vigorous approach to identifying such situations and assessing the penalty accounted for 75 percent of these penalties assessed nationwide during 1981.

As a second example, in our study of IRS' administration in three districts of the tax shelter registration late or non-filing penalty, we found that one district decided not to administer the penalty because of a belief that it was too new. The other districts were assessing late filing penalties but were using a late filing grace period greater than that established by the National Office.

Abatement of civil penalties

Taxpayers assessed a penalty have the right to request that IRS abate the assessment. However, the taxpayer must provide IRS with information which demonstrates reasonable cause for the noncompliance, evidence that the noncompliance did not occur, or other acceptable reasons for abatement. Upon receipt, tax examiners are to determine the merits of the evidence.

IRS has developed guidelines for its employees to use in abating penalties. The guidelines require that each request for abatement be judged on all the facts in hand. If the tax examiner denies the request for abatement, a notice is to be sent to the taxpayer explaining the reason for the denial and informing the taxpayer of the right to appeal the decision. If the information provided by the taxpayer satisfies the examiner, the penalty is to be abated and a notice is to be sent advising the taxpayer of such action. These abatement procedures apply to both computer-generated and manually generated penalties.

In 1984, we reported that while most IRS penalty abatements were appropriate, IRS inappropriately abated penalties in 8 percent of the abatements made in fiscal year 1981 by six selected districts and three selected service centers. On a projected basis for those 9 offices, we estimated that IRS granted 32,600 inappropriate abatements out of 407,700 total abatements made. This amounted to $21.7 million in inappropriate abatements. Abatements for reasonable cause (48,800 of the total abatements) were most in need of improvement. Twenty-six percent of the reasonable cause abatements (12,700 out of 48,800) were inappropriate.

We attributed the causes of inappropriate abatements to (1) incomplete IRS guidance defining reasonable cause, (2) minimal penalty abatement training, and (3) inadequacies in IRS review and quality assurance processes. IRS took action on our 1984 recommendations. However, much has changed since then and we do not know what IRS' current performance may be in abating penalties.

SUMMARY

In summary, we support the need for a comprehensive review of the civil penalty structure. We also believe that now is a good time to begin that review. As the tax system has become more complex so have the accompanying penalties. This has occurred with limited attention being paid to the overall structure of the civil penalty provisions, their effectiveness, or to the role they should play. The passage of the Tax Reform Act of 1986, with its extensive changes to the tax laws, provides a timely opportunity for this review.

Several issues need to be addressed. These include the purpose, need for, and effectiveness of each penalty provision, and the equity and efficiency of IRS' civil penalty administration. Past work by GAO, IRS, and others provides a starting point. But all the information necessary to respond to these issues is not presently available.

The Commissioner's civil penalties study is an important step in developing the information needed. Undertaking a review of almost 150 penalty provisions and their interrelationships is a massive task which will require time and the commitment of resources. The schedule established by the study group calls for the presentation of conclusions and recommendations to the Commissioner in July 1988. In our review, the study is an ambitious undertaking for the targeted timeframes.

The methodology of the study is evolving, but at present it does not appear to encompass the empirical analysis we believe necessary to fully address the issues. Our work will help fill part of the gap by providing the empirical evidence necessary to evaluate the effectiveness of IRS' administration of a limited number of specific penalties.

The IRS study includes a milestone for identifying additional data needed. We will continue to monitor the evolution of the study and keep IRS advised of our thoughts as that milestone nears. The Subcommittee may also wish to follow up with IRS in this regard.

Mr. Chairman, that concludes my statement. I would be happy to respond to any questions the Subcommittee may have.

Chairman PICKLE. Mr. Finch, I appreciate your brevity. But I also found your statement very interesting. You indicated in your statement that you are going to evaluate the IRS administrative handling of these penalties. That was not mentioned by IRS previously in their statements. I am interested in knowing what period of time your findings cover. We asked you to look into this question the first of the year. Are these things you found in the last 60 days or are they cases handled administratively over the years?

Mr. FINCH. It is sort of a mixed bag depending on which example you are talking about. The internal audit report is recent—late last year.

Chairman PICKLE. Are you holding this audit in every IRS district?

Mr. FINCH. No, sir. The examples I mentioned for our tax shelter audit are in three selected districts.

Do you remember?

Ms. WILLIS. I don't remember, sir.

Chairman PICKLE. Only three?

Mr. FINCH. Yes.

Chairman PICKLE. Is it your intent to have an audit in each of the IRS districts?

Mr. FINCH. After this hearing we have agreed to work with your staff about the scope of the future work we will be doing. Most of the examples I have given so far are from work that has been completed already.

Chairman PICKLE. We will be working with you.

You said the IRS administration of penalties is a key issue and it is. Then you give me some examples. When you say that on account of fictitious deposit no penalties were assessed with regard to a fictitious deposit on an employment tax return, which amounted to $437 million. How did you find that error?

Mr. FINCH. That was found by IRS internal audit.

Chairman PICKLE. Here they fail to assess penalties and we lost $470 million. Then you have a tax shelter promoter study and you found there were easily 20 errors resulting in over $4 million loss. These are your figures, or internal audit figures?

Mr. FINCH. The first figure, $437 million, was an IRS Internal Audit figure.

Chairman PICKLE. I take it that as you were looking at these studies, you are finding the administration enforcing penalties is lax in a lot of areas and it is a serious problem?

Mr. FINCH. That is right.

Chairman PICKLE. Our committee will be in close touch with you. I think this audit ought to be increased and we ought to be coordinating and asking to see that certain questions are are asked.

Mr. FINCH. I think over the coming months we will be able to provide the subcommittee with a lot more information.

Chairman PICKLE. Mr. Anthony.

Mr. ANTHONY. Thank you, Mr. Chairman.

It is my understanding that your testimony reflects that you have discovered instances where the IRS has failed to assess penalties when they were warranted. Could you address that?

Mr. FINCH. Yes, sir. I did not mean to infer that in every instance that occurs, but in work we have done we have found instances where IRS did not assess penalties when they were warranted. The two examples I mentioned were fictitious deposits on tax returns which IRS found. They sampled 426 accounts and found 217 that had fictitious deposits and none had been assessed the overstated deposit penalty.

Where we were looking at the tax shelter late registerers or nonfiling penalties, we found that IRS did not assess all the penalties that were called for by multiple acts on the part of the promoter. The reason for that was that the IRS officials in those districts were not aware that multiple accounts by the taxpayers were each subject to a penalty.

Mr. ANTHONY. That each are subject to a penalty?

Mr. FINCH. Yes.

Mr. ANTHONY. If I interpret your comment correctly, what you are saying is that they either did not know the law or they had not been trained properly to understand what their obligation could be in terms of assessment penalty.

Mr. FINCH. The national office guidance that was provided was not clear.

Mr. ANTHONY. Back to what Mr. Rangel asked earlier and what Mr. Thomas asked in followup, do you have any assessment as to whether or not assessing the penalties is due directly to lack of adequate training or is it because of applied pressure from Members of Congress?

Mr. FINCH. I think there are a lot of reasons that things do not always work as they should. One, it is a big system. IRS has over 100,000 employees and some things are going to go awry in something that large.

The Tax Code is extremely complicated, and has become more so in the last few years.

Mr. ANTHONY. I don't see why you say that, we have only changed 6,000 sections since 1981.

Mr. FINCH. I have been working on my tax return and I have not approached it with the same success as your daughter has.

Mr. ANTHONY. Well, you make more money than my daughter. I guess the consistency in the intervention bothers me, because if Mr. Thomas is able to intervene, if a constituent in my district reads the newspaper accounts for 50 percent of assessed penalties being waived and yet they were assessed penalties they didn't think about calling a Member who serves on the Ways and Means Committee or didn't know their Congressman serves on the Ways and Means Committee and therefore, knew who to call, and what buttons to press. It has to go back to what the judge called the fear, outrage and concern. I guess that is the reason we are holding these hearings.

Mr. FINCH. I support that wholeheartedly.

Mr. ANTHONY. Do you have any idea what your audit will show, whether or not we have become too penalty oriented? In other words, that is a simple solution, throw in a penalty or double or triple a penalty and think we solved the problem?

Mr. FINCH. Our study was not to look at it in that broad a scope. It was to look at a specific penalty. I think you have identified important issues and this hearing will go a long way to establishing some understanding and point to areas where we can do some empirical analysis at least on our part.

Mr. ANTHONY. Thank you. Good luck on filling out your form.

Mr. FINCH. Thank you. I need all the help I can get.

Chairman PICKLE. Mr. Thomas.

Mr. THOMAS. I hope no one assumes that anyone in my office is giving a taxpayer any unfair advantage in dealing with the IRS. They are getting what they are entitled to.

You did a review of three centers, looking at one particular penalty, and the way in which it was handled. You gave us some examples from the Internal Revenue Service's Internal Audit and some information you generated from your study. I don't think anybody thinks the IRS is perfect. You found they are not perfect. That is not news.

Are these examples that you have given exhaustive of all areas found in the three centers or are they examples of what went on?

Mr. FINCH. They can be characterized as examples, highlights. They were different.

Mr. THOMAS. So the examples that you have here are an official of the IRS Internal Audit and ours. They are not even the same three centers that you have studied?

Mr. FINCH. That is correct.

Mr. THOMAS. I am trying to put it in proper context, because I want to be fair to everybody. This was done, and obviously $437 million jumps out of the page, but how much was handled by that center? We don't want one dime that is not required legally to be paid, but I have a hard time. You said gee whiz, and after you say that, what can you do with it?

What I would like to have GAO do is to oversee or at least look over the shoulder of the IRS as it is preparing its study and conduct its study, to evaluate the study itself. One of the things that drives me up the wall here is that we do studies and when you ask what was your method of analysis, you learn it was not approached in even a minimally satisfactory way to come up with conclusions that you can work with.

I hope that is what we are going to be doing. The timetable is overly ambitious. Maybe we ought to break it down to getting something meaningful rather than move on to the next area when we have not done it in a comprehensive way, integrating not just the penalty aspects, but the mechanisms. Are we missing areas where there should be penalties and there are not, the method of application, adjudication of it, decisionmaking—who makes the decisions and are they trained properly?

That is an enormous study, I can't believe you can do anything worthwhile in the time frame we are looking at. I would like to get critical comments back as to whether or not the study is worth doing. We will have to get together with the IRS in a cooperative spirit in order to produce results that would be far more meaningful for our purposes and trying to get results in this area.

Mr. FINCH. I agree with you. We are—I am speaking of evaluating their methodology, not taking on the study ourselves.

Mr. THOMAS. As soon as you can provide us with that so we can get back to the Commissioner and ask why are we doing it this way rather than the way it was suggested. Give us a tool that allows us to ask questions before the study. It is so frustrating to ask questions after the study and they say well, we didn't know that. It could have been done up front.

It is one in terms of scope and another in terms of procedures to provide us with the kind of information we want, rather than what they want. Hopefully we can do both.

Thank you very much.

Chairman PICKLE. Mr. Schulze.

Mr. SCHULZE. Does the IRS maintain sufficient data with regard to penalties and is it maintained in such a manner that it is meaningful and useful in regard to such a study?

Mr. FINCH. That is an excellent question, Mr. Schulze. We have been involved for several weeks as a result of the subcommittee's request. We have kind of come to grips with those issues. Some of the things we see are that the penalty statistics are not aggregated in such a way that you can get that analysis. They are not aggregated by code section, so you have to do a lot of data to figure out what kind of data were applied in what time frame, and the follow-on, what was the net number of assessed, what was abated.

A missing piece of information we think is the number of penalties collected. A lot of people will feel if a penalty is going to be a deterrent to compliance it is not going to be much of a deterrent until it is collected.

Mr. SCHULZE. Collected because of deterrence or collected.

Mr. FINCH. Dollars in the till. Most of our statistics show dollars abated and net assessment, but not the money in the bank.

Mr. SCHULZE. In our discussions with them and in their studies, there has been an opportunity to sit down and say this information will be most meaningful and we have to change the collection of data in order to get this information?

Mr. FINCH. We have just gotten started, Mr. Schulze. They have gotten started and the Commissioner has been very open. I think we will have that dialog as we progress.

Mr. SCHULZE. What about the failure to assess penalties or abatements? What did you find in this area?

Mr. FINCH. We have not looked specifically at abatements in a number of years now. GAO did a review back in the early eighties. We were using 1981 tax data. We found that the IRS seemed to be doing a good job in terms of abatements. We looked at a number and came out with less than 10 percent, which we found to be inappropriately abated. We have a lot more penalties on the books since then. Frequency has gone up and a lot of other things.

I am not sure we can respond to the issues of abatements now. I think that can be explored by the IRS and the subcommittee.

Mr. SCHULZE. These are early stages not only in these hearings.

Thank you.

Chairman PICKLE. Mr. Finch, we want to thank you for coming. Our committee is going to be in touch with you. We want these audits to continue, perhaps to be enlarged, and make them broader in scope. We want to know in what level we make the inquiry.

Thank you very much. We will be in close touch with you.

Now, on the other side of this picture, we will hear from Robert Tobias, president of the National Treasury Employees Union.

You have now a chance, Mr. Tobias, to state your views as a member of the NTEU. Do you agree or disagree or what comments do you make? We know you have a statement and we will include the entire statement for the record. You may proceed in the manner you think best.

STATEMENT OF ROBERT M. TOBIAS, NATIONAL PRESIDENT, NATIONAL TREASURY EMPLOYEES UNION

Mr. TOBIAS. We are very pleased to be here to talk about this aspect of the tax law. In the summary statement that is attached—that is attached to the full statement, what I try to do is provide a basis for an analysis of the issue or the issues of the 150 civil penalty provisions of the code and we suggest to the subcommittee that the way to review these codes or these provisions is to look at the criteria that the tax penalty should meet, particularly the promotion of voluntary compliance in fairness to the taxpayer.

Those are really the issues that ought to be balanced, and also to look at the current state of the voluntary compliance among the taxpayer population, which—how much money is paid and how much money is not paid. The need for penalty notices to be understandable to the average taxpayer, the need for an ongoing system of determining whether penalties are achieving their purpose. I don't think that that has ever been done, to really take a look at does the penalty itself foster voluntary compliance or is the penalty to be instituted for some other purpose?

The need to invent penalties to encourage timely deposit of trust fund taxes and the need to review overlapping penalities for simplification.

In general, revenue agents and officers and tax examiners, tax auditors, the people who have the authority to administer these provisions in the first instance view the current penalty system as an effective compliance tool that could be made more effective. Certain penalties are perceived as complex and unfair. Overall IRS employees are most comfortable with the negligent penalty and least with the others.

IRS employees are not receiving adequate training in the penalty area. There is not enough guidance, there is not enough direction, there is not enough time spent in detailing what the penalties are, how they are to be administered.

Of course, the impact of that is that disparate implementation of the penalties and somebody pays and somebody else doesn't pay because the training, the on-going training we believe is inadequate. And IRS employees generally believe that fairness suffers because they are given too little latitude in the penalty area and there is insufficient guidance to employees to ensure consistency in applying the penalties.

So that is the overview of how we see the civil penalty provisions of the code; and we attempted, Mr. Chairman, to answer in the testimony itself, the questions you posed. I would be pleased to answer any questions you might have at this juncture.

[The prepared statement follows:]

NTEU
The National Treasury Employees Union

Summary Statement
of
Robert M. Tobias
National President
National Treasury Employees Union

Civil Penalty Provisions of the Internal Revenue Code

I. The fundamental issues the Subcommittee should consider in reviewing the current penalty system are: (a) the criteria that tax penalties should meet, particularly promotion of voluntary compliance and fairness to the taxpayer; (b) current state of voluntary compliance among the taxpayer population; (c) need for penalty notices to be understandable to the average taxpayer; (d) need for an ongoing system of determining whether penalties are achieving their purpose; (e) need to strengthen and retain penalties that encourage timely deposit of trust fund taxes; and (f) need to review overlapping penalties for simplification.

II. In general, IRS Revenue Agents and Revenue Officers view the current penalty system as an effective compliance tool that could be made more effective. Certain penalties are perceived as complex and unfair.

III. Overall, IRS employees are most comfortable with the negligence penalty and least comfortable with the "failure to pay" and "substantial understatement" penalties.

IV. IRS employees are not receiving adequate training in the penalty area.

V. IRS employees generally believe that fairness suffers because (a) they are given too little latitude in the penalty area, and (b) there is insufficient guidance to employees to ensure consistency in applying penalties.

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Mr. Chairman and Members of the Subcommittee:

I am Robert M. Tobias, National President of the National Treasury Employees Union. NTEU is the exclusive representative of over 120,000 Federal workers, including virtually all employees of the Internal Revenue Service. I am accompanied today by Patrick Smith, Director of Legislation, and Paul Suplizio, legislative consultant.

IRS employees, particularly revenue agents who examine taxpayer returns and revenue officers who collect delinquent taxes, are in continuous contact with the taxpaying public and can offer some insight into the role of civil penalties in our voluntary compliance system.

I will respond to each of the five questions that the Subcommittee addressed to NTEU in its request for our participation here today. Please understand that our response is preliminary, as we have only recently begun to investigate this area at the Subcommittee's request.

1. What are the fundamental issues and questions the Subcommittee should consider, at the outset, in reviewing and analyzing the current penalty system?

We believe the first challenge is to develop a set of criteria that tax penalties should meet as integral components of the tax administration system. We believe the highest priority criteria are promotion of voluntary compliance, and fairness to the taxpayer. Penalties make no sense if they fail to promote compliance and deter non-compliance. They will be ineffective, and will actually undermine compliance, if they are widely perceived by the taxpaying public as unfair. Tax penalties should also be understandable to the public, relatively easy to compute and administer, proportionate to the seriousness of the offense, uniformly imposed on taxpayers in similar circumstances, and applied with sufficient discretion to permit their reduction or abatement as conditions warrant.

Any overhaul of tax penalties should take into consideration the current state of our voluntary compliance system. The 150 different penalties we have on the books today are the result of abuse of the system in the form of tax shelters and the audit lottery. In the late sixties and early seventies, voluntary compliance stood at 90 percent and IRS was examining a healthy 2.5 percent of all returns. In those days, the only penalty to speak of was a relatively weak negligence penalty. Today, audit coverage has plummeted to 1.2 percent, we have a tap gap of $100 billion and more than $50 billion in uncollected taxes, and we have only begun to get the tax shelter problem under control. By all means, let's overhaul the civil penalties and focus them better on compliance and fairness. But let's recognize that IRS still has serious enforcement problems and penalties are a tool for deterring non-compliance. Let's not throw out the baby with the bath water.

NTEU strongly believes that civil penalties should be structured so they are fair to the average taxpayer, not just to the taxpayer who can afford professional representation. IRS employees are keenly aware that one of the elements making for unfairness in the current system is that low and middle income taxpayers are bearing the brunt of assessed penalties. Those with professional representation are more likely to have their penalties abated, particularly in cases settled in Appeals.

Penalty notices should be understandable to the average taxpayer. About 90 percent of the penalties being imposed are generated by computer, and roughly 50 percent of the penalties assessed in these notices are ultimately abated. It does not promote compliance if the taxpayer believes he or she is being unfairly assessed, so notices must be both accurate and understandable. The penalty-generating process within IRS could stand further scrutiny and quality control.

To our knowledge, there is no current system within IRS for determining whether a penalty is achieving its purpose. For example, judging from the ever-increasing number of dishonored checks in recent years, it is evident that the dishonored check penalty is not achieving its intended goal. IRS should have an internal system for monitoring the effectiveness of each penalty and determining whether the penalty is being applied uniformly Service-wide. It would then be in a better position to provide Congress with information on what changes should be made.

IRS employees strongly support strengthening and retaining penalties that encourage accurate and timely deposit of withholding and trust fund (Social Security) taxes. IRS has determined this area to be one of significant non-compliance and, if anything, penalties should be strengthened in this area.

Finally, there is little doubt that overlapping and "stacked" penalties, where more than one penalty is applied to the same delinquency, have contributed to a perception of unfairness of the current system. Congress should not rule out circumstances where more than one penalty would be appropriate. However, any review of the penalty structure should deal with the question of overlaps in an effort to make penalties simpler, more understandable, and more clearly focused on compliance and fairness.

2. What are the general views of IRS agents regarding the fairness and effectiveness of the current penalty system?

In general, IRS revenue agents and revenue officers view the current penalty system as an effective compliance tool that could, however, be made more effective. Some agents in Examination and Collection feel that certain penalties are complex and unfair, and don't reinforce compliance. They say that taxpayers are penalized for being unfamiliar with certain sections of the law, such as withholding procedures or 1099 reporting requirements. These agents believe that taxpayers are unaware of, and do not understand, the many penalties now existing in the Internal Revenue Code.

IRS employees believe there is inconsistency from agent to agent, district to district, and district to Service Center, with regard to abatement of penalties. Some take a liberal view toward abatement, and some a much stricter view. This is a difficult area, because employees also believe they should be given sufficient discretion to fit the penalty to the case. The general view is that there is a need for more consistent policy, additional guidance, and tighter controls on assertion and abatement of penalties.

3. In assessing penalties, which provisions do the agents feel most comfortable/less comfortable with in terms of harshness and/or complexity?

Overall, IRS employees are most comfortable with the negligence penalty and least comfortable with the "failure to pay" and "substantial understatement of tax" penalties. IRS employees believe the "failure to pay" penalty of Section 6651 should be eliminated. This penalty on a delinquent balance is now 12 percent per annum, on top of interest at 11 percent per annum. At these rates, accruals to tax become very sizeable. The late payment penalty has always been difficult to explain to taxpayers, who are perfectly willing to pay the interest, but object strenuously to the additional amount because they feel they are being penalized twice.

Some revenue agents feel that the 25 percent "substantial understatement" penalty of Section 6661 is often an unfair penalty. They point out that taxpayers can be assessed this penalty even though they paid a substantial amount of tax during the year and received a large refund. If, after audit, additional taxes are assessed, the substantial underpayment penalty can be imposed even though the additional assessment is less than the total amount of tax originally paid for the year. Revenue agents believe that additional guidance should be given to allow waiving part of the penalty in appropriate circumstances. Another possibility would be to combine the negligence, valuation, and substantial understatement penalties into a single penalty that could be varied according to the severity of the case.

Some revenue agents believe the Section 6653 penalty for negligence and civil fraud has become too complex in cases where fraud is asserted. At present, the portion of the tax change attributable to fraud must be separated from the non-fraud part and various penalties such as late filing and negligence must be computed and assessed on the non-fraud portion -- a complex and time-consuming procedure.

Revenue agents do not believe the 5 percent negligence penalty is adequate to serve as a deterrent. In many cases, there is a fine line between negligence and fraud, and negligence is more frequently asserted. A 5 percent penalty for intentional disregard of rules or regulations is not considered effective.

Revenue agents are concerned about some aspects of the Section 6694 penalty for understatement of taxpayers' liability by an income tax return preparer. As agents have to work with return preparers on a daily basis, they must consider the impact of a penalty assessment on the cooperation they will receive in the future. In this case, agents would prefer not to have flexibility. Rather, they believe the criteria for the penalty should be clearly spelled out, and the penalty should be applied uniformly when the criteria are met.

The section 6721 penalty for failure to file certain information returns can be very unfair, according to revenue agents. It is possible to assess up to $100 per information return, up to a total of $100,000, for not providing these returns, even though the tax involved may only be a few dollars per return. This is considered a severe penalty for failure to issue these returns, which is often due to errors of omission or interpretation. One solution to this problem would be to combine the various penalties for failure to file or complete information returns into a single penalty, which could be varied depending upon the severity of the transgression.

IRS employees believe the Section 6656 penalty for failure to make deposit of taxes or overstatement of deposits has become too complex. At one time, this penalty was 5 percent of the undeposited tax and the computation was simple. Now it is nearly impossible to compute this tax manually or by computer and get the same answer as computed at the Service Center. This is often because of intervening payments and deposits during the tax period. As a result, employees are frequently unable to show the taxpayer how the Service arrived at the penalty amount.

IRS employees believe the dishonored check penalty of one percent of the amount of the bad check is too low, and does not act as a deterrent. The number of bad checks has greatly increased over the years, yet the penalty has remained minimal. It should be raised.

4. Do agents receive adequate training in the penalty area?

NTEU believes that new agents are receiving good training in the penalty area. However, there is a widespread lack of continuing education on penalties (and numerous other subjects) for the permanent workforce. Many veteran employees do not feel adequately trained in penalties and changes in the law. Many are not thoroughly conversant with penalty guidance and the abatement process. NTEU continues to stress with IRS management the need for a strong program of continuing professional education to upgrade the competence of the workforce and enhance respect for the Service on the part of the taxpaying public. We believe adequate training is a morale builder for employees and helps attract and retain competent people in the Service.

5. Are agents given too much or too little latitude in this area?

IRS employees generally believe they are given too little latitude in the penalty area. Many revenue agents believe they have little or no latitude in the substantial underpayment area, where more discretion would promote compliance and fairness. Collection officers have some latitude in recommending penalty assessments and abating penalties, but there are large disparities in the way these are applied.

The issue of the proper amount of latitude for employees is a difficult one. IRS employees obviously require sufficient latitude to equitably relate the penalty to the circumstances. At the same time, there should be sufficient uniformity and consistency of application so that taxpayers in similar circumstances are treated the same. Part of the problem lies in training, so that some employees will not be tempted to honor all requests for abatement, which in turn creates problems for those who do not. Taxpayers and practitioners complain the loudest when they are denied an abatement after another employee granted one in similar circumstances. We believe that it is incumbent upon management to promulgate adequate guidance to employees spelling out the criteria for assertion of various penalties, and to conduct periodic assessments of the effectiveness of the penalty program.

Mr. Chairman, this completes my statement. We appreciate you soliciting the views of IRS employees on this important issue, and look forward to continuing to work with the Subcommittee as your investigation proceeds. My staff and I will be glad to answer any questions.

Chairman PICKLE. Thank you, sir. When you say the IRS employees are not receiving adequate training and this statement that was made just previous to you by the GAO, if you are not receiving adequate training, have you, the NTEU, protested that you are not getting adequate training?

Mr. TOBIAS. On a regular basis.

Chairman PICKLE. Is it throughout the IRS system you are asking for more training and you are not getting it?

Mr. TOBIAS. Without question.

Chairman PICKLE. What is their answer to you when you say you need more training?

Mr. TOBIAS. Well, the answer is—the answers vary depending on the years. We only have so much money, so much time to do much training.

This is a lesser priority than teaching somebody about the 1986 Tax Code revisions or the other problems that arise.

Chairman PICKLE. Then you have asked for more training, more classes and you have been refused?

Mr. TOBIAS. That is correct.

Chairman PICKLE. That is your testimony?

Mr. TOBIAS. That is correct, Mr. Chairman.

Chairman PICKLE. Throughout all the districts?

Mr. TOBIAS. Oh, sure. We meet with the IRS at the national level and then we meet district by district and that is an ongoing issue.

Chairman PICKLE. Is this something we should expect? Do you always ask for more training, more employees; does every division ask for the same thing and the director can't give it to them?

Mr. TOBIAS. I think not.

Chairman PICKLE. Why do you say, they don't have enough manpower, enough personnel?

Mr. TOBIAS. I think that that is the response that—the IRS says we have to set priorities and this is not implicit. Nobody says this is a lesser priority but implicit in the response is this is a lesser priority.

Chairman PICKLE. Well, how do you feel, your organization, when you have a person you are auditing and he has a violation of some provision of the code that would fine him, we will say $100 as a unit of measurement, yet, by the time he finally gets to it and you are reviewing him, his interest and penalties and other things are $300, two or three times the original penalty.

How do you feel about that?

Mr. TOBIAS. Well, the people we represent, employees of the Internal Revenue Service feel their primary mission is to foster voluntary compliance. When you have that kind of penalty that you just described, I believe it discourages voluntary compliance and does not encourage it.

It fosters litigation and discourages compliance.

Chairman PICKLE. Well, if that is the case, should we do away with penalties?

Mr. TOBIAS. I don't think we should do away with the penalties because I think that penalties have a place in the tax law. I think people who, for example, send in checks that bounce, I think people who fail to pay their trust fund taxes, that we have to have penalties for people who don't violate the law, but we have to have sufficient flexibility so people don't view the law as punitive.

When they view the law as punitive, they stop paying and start fighting.

Chairman PICKLE. Mr. Schulze.

Mr. SCHULZE. Thank you, Mr. Chairman.

Mr. Tobias, in your testimony you stated that about 50 percent of the computer generated penalties and about 90 percent of all penalties are ultimately abated. Does this mean that the penalty system is working well or is it symptomatic of flaw or a flaw—inherent in the system?

Mr. TOBIAS. I don't have the empirical evidence to come to a definitive answer to that question. My sense is the anecdotal evidence that I have says there are some flaws in the system which we point out in the testimony.

Mr. SCHULZE. More systematic plan, a matter of more training and implementation?

Mr. TOBIAS. It is, I believe, because whatever—if you have a penalty system where discretion is involved, you have to have training to the people who are administering that system.

So long as your system is not totally automatic every step of the way, and I don't think it can be, you have to have training. So it is both.

Mr. SCHULZE. I share your concern in training. One of the problems with the amount of turnover in the IRS is either inadequate or insufficient training, in my opinion. Have you made any recommendations on better procedures for training, a better structure or system for training that would make sure not only initial training, but retraining as time goes on. Is there a certain number of hours per year or per week or per month which the employees need to stay up to speed?

Mr. TOBIAS. I think the IRS, as I point out in the testimony has been doing a very good job with brand new people. You take a look at the code, take a snapshot of the code at the time you are hired. You can teach somebody about the code. But the problem is that those people who stay on 3, 5, or 14 years and particularly over the last period of time when there has been so much change in the code, the issue is how do you keep those people up to speed.

The way the IRS has done it is through their continuing educational programs which last anywhere from 3 to 5 days a year. In light of what has gone on——

Mr. SCHULZE. Are they mandatory or voluntary?

Mr. TOBIAS [continuing]. Mandatory. They have a formal program of continuing education, 3 to 5 days, and then supplemented by stuff at the work site. But the problem or—the ongoing training at the work site is not sufficient, it is not structured, not the kind of an analytical, thoughtful approach you get when you step back and say, I am going to focus on something.

Mr. SCHULZE. Mostly to a supervisor and we will, in my opinion, this is important, and as a consequence, I am going to call my folks in.

Mr. TOBIAS. In my monthly meeting, I am going to talk about this issue, that is correct.

Mr. Schulze. So there is not a lot of guidance or direction from above on this. Tell me this: Is the information collection sufficient that somebody at the national level should say, we have a problem in this area? In other words, our information feedback tells us that we need education in areas A, B, and C or X, Y, and Z; or is it relatively hit or miss? The bottom line is, is there a method without being too expensive that would bring that information?

Are we going to spend more money trying to collect that information than it is worth in the long run?

Mr. Tobias. I am not aware of this systematic information gathering system that says the priority on training this year should be A as opposed to B or C or D.

Mr. Schulze. There are not little flags that pop up?

Mr. Tobias. That is the way I believe it happens. The flags pop up. Somebody says I have been hearing a lot of complaints about penalties lately, maybe we ought to do something about it, but not a systematic way of approaching the problem.

Mr. Schulze. Thank you, Mr. Tobias.

Chairman Pickle. Mr. Anthony.

Mr. Anthony. Thank you. Mr. Tobias, on page 3 of your testimony you talk about section 6651. Is that a recommendation that you would make to this subcommittee, that we just abolish the penalty section 6651.

Mr. Tobias. I believe it is section 6651, Mr. Anthony.

Mr. Anthony. And the failure to pay; what type of situations have you run into that would encourage you to come and testify to a recommendation that that section be totally eliminated?

Mr. Tobias. I think it is—in that paragraph, as I go on to say, that the penalty on a delinquent balance is now 12 percent per annum on top of interest at 11 percent per annum. At these rates, the tax becomes very sizable. The late penalty has been difficult to explain to taxpayers, the subject of the additional amount. They feel they are being penalized twice.

Mr. Anthony. I am not so sure I agree with the taxpayer in that case. If they fail to pay, it is as though they are taking a loan from the Treasury, otherwise we wouldn't have the cash. So they either have to borrow it from the bank or the Treasury. If they have to borrow it from the bank, they have to pay interest. We are saying there you have got to pay some type of carrying charges if you are going to fail to pay something that is owed.

Over and above that you put a penalty on it for the account itself.

Mr. Tobias. We are suggesting instead of having two different—I mean I agree with you. If somebody intentionally doesn't pay or negligently doesn't pay, they ought to—there ought to be consequence to that. What we are saying is that when you have the two separate penalties, we would suggest you have one penalty that would be more, one penalty that could go up to, you know——

Mr. Anthony. If you don't like the bifurcation that occurred in 1981 and 1982, you recommend we revisit that and go back to a unitary penalty, interest and penalty, rather than a bifurcated system.

Mr. Tobias. That is correct.

Mr. Anthony. You say 5 percent is not severe enough and you feel if we go look at it, we should raise the 5 percent on negligence to a higher number?

Mr. Tobias. That is correct.

Mr. Anthony. You think that would help with the compliance part?

Mr. Tobias. Yes, sir.

Mr. Anthony. I think those are very good suggestions. Back on the same page, you also talk about the substantial underpayment 25-percent penalty being perceived as an unfair penalty.

Would you recommend we revisit it and change that also?

Mr. Tobias. Yes, sir.

Mr. Anthony. And what would be your recommendation?

Mr. Tobias. What we are saying is that in that area that the revenue agents ought to be given some ability to waive part of the penalty in appropriate circumstances, and the other thing that I mentioned before would be to combine the negligence evaluation and substantial underpayment penalties into a single penalty that could be varied according to severity of the case.

In other words, instead of having to deal with three issues and the taxpayer says, hey, look, I don't owe this and I am going to litigate, you have one penalty that can be decided and then you are just talking about one instead of three.

Mr. Anthony. The judge says that it complicates his situation in court because the lawyers try to move compliance out of fraud into another section because it lessens the client's overall exposure.

Mr. Tobias. That is correct.

Mr. Anthony. You are saying that even before it gets in the tax court your agents have to make that same determination and it becomes very time consuming and complicated, and it could go much smoother and easier if it were all combined?

Mr. Tobias. I believe that is correct.

Mr. Anthony. You also address the fear outrage and comment that Judge Sterrett also made that he sees people before the tax court.

Mr. Tobias. I think so because if you have one penalty, one issue, how much as opposed to whether I am a bad person, I think it is easier to decide.

Mr. Anthony. I think those are very strong points that you have made and I appreciate your testimony. Let me test something out and see if I am correct.

It is my understanding that 90 percent of the assessments are computer driven, 90 percent of the penalties are computer oriented and driven; is that consistent with your understanding?

Mr. Tobias. That is correct.

Mr. Anthony. It is also my understanding from the data submitted to the committee that no penalty is assessed. In other words, it is 45 percent of all penalties that are originally proposed to be assessed are dropped.

Mr. Tobias. I think that follows.

Mr. Anthony. How much more discretion do you need? In other words, you want more discretion to move that number higher. Or is there a particular area that you feel like your hands are tied and you need more discretion?

Mr. TOBIAS. You know, I don't——

Mr. ANTHONY [continuing]. What bothers me is this, say Mr. Thomas may have a wonderful working relationship, and Mr. Rangel obviously has got some problems, and I am not sure where I stand.

Mr. TOBIAS. In good stead, I am sure.

Mr. ANTHONY. I guess I am in good stead because I am not complaining. The more discretion that you have, inadequate training programs in the system, it tells me there are going to be more disruptions between the agency and taxpayers.

Mr. TOBIAS. I think what you are going to find with the 90 percent computer generated penalities, that those—that that 90 percent have to do with things like the under-reporter program, where you are dealing with small sums of money.

What my testimony focuses on are the large sums of money that come about as the result of individual and corporate audits.

Mr. ANTHONY. In complicated cases, you feel there needs to be much more training and you feel like you need much more discretion?

Mr. TOBIAS. That is correct.

Mr. ANTHONY. Then you feel like those cases would be settled before they end up in Judge Sterrett's tax court?

Mr. TOBIAS. I believe that to be true.

Mr. ANTHONY. Less frustration and outrage by the taxpayers?

Mr. TOBIAS. Yes, and for legal fees——

Mr. ANTHONY. I used to be opposed to that, but it doesn't bother me since I am not out there practicing. I get my money from the Treasury now on a monthly basis. As long as we can keep you all healthy. We took care of the tax lawyers and the accountants in 1986. They will be making millions for years to come, wrestling around with what we did in 1986.

Mr. Chairman, I think he made good points and I think he addressed the point you brought up in the very beginning. He didn't waltz around and dance around. He got right into the heart of it. He spoke with conviction and I think it is valuable to hear that.

Mr. TOBIAS [continuing]. Thank you, Mr. Anthony.

Chairman PICKLE. Mr. Tobias, Commissioner Gibbs testified earlier this morning with respect to the computer aspect, that although 90 percent of them are computer driven, that wasn't necessarily a final decision. It was sort of a preliminary inquiry, that based on 1, 2, 3, 4 input into the computer, it would appear that you should be penalized.

Now, he says you almost have to start from that basis. Do you disagree with that?

Mr. TOBIAS. No, I do not.

Chairman PICKLE. You are saying that while 90 percent are there and 50 percent are abated, a number of them will probably be abated because we are simply trying to get information?

Mr. TOBIAS. Yes. You understand, Mr. Chairman, that that under-reporter program which generates all that paper is only looking at paper. It is only matching 1099's or whatever else and sending you a letter and saying based on what I see you owe money and if you owe that money, this is the penalty.

Mr. ANTHONY. Would you yield at that point?

Chairman PICKLE. Yes, Mr. Anthony.

Mr. ANTHONY. Could you not arrive at the same conclusion if you soften the approach a little, rather than saying you definitely owe and have been assessed blank dollars? You could put a caution in there and say that based on the information we have presently, it appears that you have under-reported and there may be the possibility of a penalty in the amount of so much?

Mr. TOBIAS. Well——

Mr. ANTHONY. What is the difference between saying you may owe us some money and saying, yes, you owe us a lot of money and the taxpayer says, yes, but you abate 50 percent of it so I know you are bluffing to begin with.

Mr. TOBIAS [continuing]. Particularly with that under-reporter program, I guess I would answer it two ways. In terms of tax owed, normally a bank has filed that you received interest and you didn't pay tax on it. By looking at your return, you owe the money. You owe the tax on your failure to include the interest in your gross income.

I don't know whether it would make good sense to say that perhaps you owe the money. I think the issue is you owe it, unless you submit something to say that a mistake was made. I think that maybe something could be done in the penalty area, but not in the money owed area. I think those are pretty clear.

Mr. ANTHONY. Mr. Chairman, what I find fascinating, he is defending the taxpayer saying something needs to be done and in the next paragraph he is defending the tax collection system. I guess in that case, you are a credible witness.

Chairman PICKLE. I would ask——

Mr. TOBIAS. I believe, and you know, this is—I approach this testimony as I said from the beginning, with the idea in mind that the goal is to foster voluntary compliance. I think that the Internal Revenue Service, at least for several years, got away from that, and I think that ever increasing tax compliance gap that we saw growing over the past few years measures that problem.

If we don't do something with that and start making that come down, then collecting taxes the way we now do won't be a viable option for us. So I really believe in the system and I believe in fostering that voluntary compliance ought to be the goal of IRS and anybody who touches that code.

Chairman PICKLE [continuing]. Let me ask you a broader question and separate apart from penalties. How do you find, as a representative of NTEU, the average taxpayer when he comes to the IRS for assistance? Does he come seeking information? Is he unhappy, is he angry, or is he just mad as hell? What is the general attitude of a person who comes to the district offices looking for help?

Mr. TOBIAS. I think—looking for help?

Chairman PICKLE. Well, looking for an answer to the problem.

Mr. TOBIAS. If someone is—I would put someone coming to the taxpayer service program asking for information in a different category than a person who is coming as the result of a letter saying you are going to be audited and then a different category from the person who has received a letter from the service center saying it looks like you owe some money.

But I think that the taxpaying public falls into all the categories you describe. Some are angry.

Chairman Pickle. We have pending now before the Congress on the other side, a taxpayer's bill of rights. I don't know whether you are familiar with the provisions being advanced. Do you favor the passage of a taxpayer's bill of rights?

Mr. Tobias. Well, we have testified both in the House and the Senate on the so-called taxpayer bill of rights and there are some provisions in there that we have supported and others that we have totally opposed. I think it is a mixed bag.

Chairman Pickle. What does that mean? Do you have any question about the pending bill?

Mr. Tobias. For example, on the issue of whether or not the burden of proof should be on the Internal Revenue Service——

Chairman Pickle. That is not in the bill. That has been eliminated from that bill?

Mr. Tobias. Are you talking about the bill that ultimately came out of the committee?

Chairman Pickle. Yes.

Mr. Tobias. The Senate committee that is over there?

Chairman Pickle. I am not trying to analyze each provision, but I am talking in broad terms. Should we pass a taxpayer's bill of rights?

Mr. Tobias. Well, I think there are some provisions that the Senate addressed in that bill that makes some sense. I think it is misnamed as a taxpayers' bill of rights. I think there are some provisions that have been unfair to taxpayers that the Senate sought to address, particularly raising, for example, the amount of money that someone can maintain and not have seized. That makes sense to me.

Chairman Pickle. Well, in that respect, do you need a taxpayer agents bill of rights?

Mr. Tobias. I think we certainly do. There are an awful lot of revenue offices that go out and collect taxes. Right now the officers who collect taxes are subject to more assaults and more threats than any other employee in the federal sector. FBI agents, DEA agents included.

Chairman Pickle. Thank you very much. Any members have any questions of Mr. Tobias?

Mr. Jacobs. I yield to Mr. Schulze.

Mr. Schulze. I want to thank Mr. Tobias for a very interesting and candid presentation.

Mr. Jacobs. My preliminary question is, do you think that the proposal to grant more discretion would save as much attorneys' fees as the tax simplification cost additional fees? Will we break even, do you think?

Mr. Tobias. I don't know. I don't have a dollar analysis. I think that more discretion would increase voluntary compliance and that would be my goal.

Mr. Jacobs. You mentioned just now an exemption when you levy for delinquent taxes. I am a little confused about that because I thought I got that in the law back in 1975. Was I misinformed when the committee voted for it.

Mr. Tobias. What the Senate did was to increase it.

Mr. JACOBS. The exemption?

Mr. TOBIAS. That is correct.

Mr. JACOBS. Emulating the garnishment proceedings of several States.

Mr. TOBIAS. That is correct.

Mr. JACOBS. Thank you for your testimony.

Chairman PICKLE. Thank you, Mr. Tobias. We appreciate your testimony.

Now, the Chair will call up a panel and we will try to move along as quick as we can. We have two other panels this afternoon.

The panel consists now of Mr. Charles W. Hall. Mr. Hall is chairman of the Section of Taxation of the American Bar Association. Mr. Hall, which are you?

Mr. HALL. Right here.

Chairman PICKLE. Charles Rau, where are you, vice president of taxes, with the MCI Communications Corp. I understand you represent the Tax Executive Institute.

Mr. RAU. Yes, sir.

Chairman PICKLE. We also have with us today, Mr. Louis Mirman, past president, National Society of Public Accountants; Mr. Donald Skadden representing the AICPA; Mr. David Silverman representing the National Association of Enrolled Agents; and Mr. Al Golato, from H&R Block. Gentlemen, you represent a very impressive group who are actively in the field and can give us some practical testimony. So I ask you to proceed in the order I have called your names.

Let me ask that each one of you summarize your statement because we have two other panels. I don't want to hold them here unnecessarily. To the extent you can, I hope you can testify or summarize, and we will come back for questions.

Charles Hall representing the American Bar Association. Mr. Hall.

STATEMENT OF CHARLES W. HALL, CHAIR, SECTION OF TAXATION, AMERICAN BAR ASSOCIATION

Mr. HALL. Thank you, sir. I speak only for the tax section of the ABA, but it has 28,000 members in it and a great many of them are quite expert and experienced in civil tax penalties. We have a committee of those people who are experts, who have been studying the penalty situation for a considerable period. They have drafted a 200-page report in rough draft form that we are working on and which we hope soon to present to the subcommittee.

Chairman PICKLE. I understand you are going to try to complete that by late summer; is that correct?

Mr. HALL. Yes, sir, I hope earlier than that, within a few weeks.

Chairman PICKLE. Good.

Mr. HALL. We feel committed to enhancing voluntary tax compliance. We believe civil penalties are an important part of tax compliance. We also believe for these civil penalties to be viable and important, they have got to be understandable. They have got to be fair, got to be prospective, and we believe they should be used not to raise revenues, but to punish noncompliance. We are concerned about the civil penalty structure and you ask why.

Some of this will be repetitious. First, there are too many penalties. One-hundred fifty is, perhaps, more than we need. The penalty structures are too complex. The penalty structure is not coordinated. I would say that today many taxpayers and their representatives openly question the fairness of this structure.

If we can decrease the number of penalties, if we can reduce the complexity, if we can coordinate them better, the perception of fairness should be better. What I just said is cumulative of your own statements and those of many of the witnesses. I believe there is a message just in the fact that you are getting an avalanche of these comments: too many, too complex, not coordinated.

Let me give an example of complexity and lack of coordination. Most taxpayers are subject to five basic penalties. Three of them are of longstanding duration: delinquency, negligence, fraud. Two are newer. Incorrect valuation and understatement, substantial understatement. In the Internal Revenue Code, there are just three instances in which these five basic penalties are coordinated.

The delinquency penalty can't be assessed on the same portion of a tax deficiency on which fraud is assessed. Second, the negligence penalty, same thing, can't be assessed on the same portion of the tax deficiency on which fraud is assessed.

Third, either the valuation overstatement or the substantial understatement may be assessed on the same portion of the deficiency, but not both. There is no other coordination of these penalties. There is no other coordination of these penalties. Therefore, several of them may be imposed for the same understatement of tax or the same misconduct.

For example, a delinquency and negligence penalty and understatement penalty may apply to the same deficiency. Further, the fraud penalty is applied only to the fraud-tainted portion of the deficiency, only the part tainted with fraud. The negligence penalty applies to the whole deficiency.

A taxpayer could be subject to four penalties on a single deficiency, negligence, fraud, delinquency and substantial understatement. For further example, these rates could be coordinated a lot better. The delinquency penalty ranges from 5 percent for a 1-month delinquency to 20 or 25 percent.

The negligence penalty is 5 percent, but it applies to the entire deficiency. The fraud penalty is 75 percent, but it applies only to the tainted part of the deficiency. Both fraud and negligence have interest-based additions on top of everything else. It can be misleading to think of the 5-percent negligence penalty as being smaller than 75-percent fraud penalty because there are times when the 5-percent negligence penalty on the entire deficiency plus the interest-based additions is greater than the 75-percent fraud penalty on the tainted part.

In the short written statement we filed last week, we make a number of suggestions. In our lengthy report now in preparation, we try to cover every single penalty. And we make a number of specific suggestions like the inference of fraud that—the presumption, let me say, of negligence that arises on the deficiency because a 1099 was not picked up in the return, so that taints the deficiency, presumptive negligence. We suggest that that be repealed.

We suggest that the valuation penalties be repealed because they are complex, because it gets into judgment and because we have plenty of other penalties that could take care of that sort of thing.

We suggest for further example on the information return penalties that they not be cliff penalties. You miss filing some kind of information and you fall off the cliff. The entire penalty is due, instead of perhaps like some of the under—the failure to pay penalties, having a staggered amount.

You are delinquent for one day, it is one penalty; for a week it is another penalty. It increases. We don't think that encourages compliance and so forth. At the risk of being presumptuous, I will wind up by saying we really endorse the statement you made in the beginning that this is going to take some time.

At risk of being presumptuous, we urge you to take a lot of time to study this. This penalty fabric has been woven over a long period of time. It is uncoordinated in many ways, complex and lengthy. It is frayed and it is worn. And we hope that you can do something, study it and do something so it will be simpler, more understandable and coordinated and so that it effectively helps voluntary tax compliance.

We will do anything we can in the ABA tax section to help you. We will file this report and we can even on short notice have some pretty experienced people from the real world come over and visit with your staff, not with any policy bias, but to brainstorm how a statute ought to read and what is the effect in the real world. Thank you.

[The statement of Mr. Hall follows:]

CHARLES W. HALL
CHAIR, SECTION OF TAXATION
AMERICAN BAR ASSOCIATION

Mr. Chairman and Members of the Committee:

Introduction

I am Charles W. Hall, Houston, Texas, Chair of the Section of Taxation of the American Bar Association. These views are presented on behalf of the Section of Taxation. They have not been approved by the House of Delegates or the Board of Governors of the American Bar Association and, accordingly, should not be construed as representing the position of the Association.

For some months our Committees on Civil and Criminal Tax Penalties and Administrative Practice have been making a study of the civil penalty structure. The most recent draft of a report those Committees are preparing to the Section as a whole is nearly 200 pages long and addresses in some fashion each of the 150 or so civil penalties now in existence. We estimate it will take several more weeks to complete. We will be pleased to furnish this Subcommittee and its staff with that detailed report upon its completion and approval by the Tax Section Council. Today, however, I intend to address only a few key points we believe may help guide this Subcommittee's review of the civil penalty structure.

Rationale for Penalties

We have identified four overlapping rationales supporting a civil penalty structure for taxpayer misconduct:

1. To enhance voluntary disclosure of relevant tax information thereby discouraging tax evasion. Helvering v. Mitchell, 303 U.S. 391 (1938).

2. To indemnify the government against the loss it suffers as a result of having to investigate and discover the taxpayer's failure voluntarily to disclose the relevant tax information. Helvering v. Mitchell, supra.

3. To deter noncompliance by increasing its costs. See Administrative Report to Administrative Conference, "Administrative Procedures of the Internal Revenue Service" October 1975, p. 625.

4. To deter noncompliance by putting into the minds of taxpayers generally the knowledge that other taxpayers are complying with the law or are being punished when they do not. Kelley and Oldman, Readings on Income Tax Administration, p. 486.

Each of these points relates to the overall objective of encouraging voluntary compliance with the tax laws. This is consistent with the recent report of the ABA Commission on Taxpayer Compliance, which took the position that civil penalties are an appropriate part of the effort to achieve voluntary compliance, although the effort must include a large number of other elements as well.

Principles for Evaluating Penalties

The underlying objective of the penalty system provides a basis for developing principles by which the system can be evaluated and improved. For example, if penalties are to be effective in the role of enhancing voluntary compliance they must be understood by the average taxpayer whose behavior is to be influenced. As a result, individual penalties should be relatively simple to understand. Also, penalties will be more effective in enhancing voluntary compliance if they are perceived as logical and fair in relation to the particular misconduct penalized. Penalties that may be applied to conduct that is reasonable or appropriate will be seen as illogical and unfair, and hence create resentment rather than a willingness to cooperate. Even more clearly, penalties for acts not proscribed when the acts were done cannot enhance voluntary compliance. Finally, because civil penalties ideally promote 100 percent voluntary compliance, the revenue effect of penalties should come from increased tax collections, not increased penalties. Increased revenues from penalties probably indicates the existence of other problems in the voluntary compliance system and would not be good news.

Need for Reexamination of Penalty Structure

As an overall comment, we agree with the Treasury's 1984 statement of the President that:

> The penalty provisions under existing law are overly complex and often result in inconsistent treatment of similar violations. Penalties have been added piecemeal to the Code as new filing and reporting requirements have been legislated. The inconsistencies in the present penalty structure undermine horizontal equity among taxpayers and make the penalty provisions difficult to understand and administer. "Tax Reform and Fairness, Simplicity and Economic Growth" (General Explanation of Treasury Dept. Proposals), Vol. 2: P. 406 (1984).

The following observations on the current penalty structure suggest the need for a reexamination of that structure at an early date:

1. The current structure is needlessly complex. We have counted 13 different standards for conduct subject to penalty. It should be possible to do with several fewer standards and to develop some greater precision of expression about exactly the conduct to be penalized.

2. The structure is not internally coordinated. For a single act of misconduct, more than one penalty can apply resulting in an aggregate penalty that is considerably larger than any of the single penalties. It should be possible to develop some greater precision of expression about exactly what the penalty is to be for any particular misconduct.

3. Taxpayers and tax practitioners are openly questioning whether the current penalty structure is always fair, which is to say appropriate, in light of the type or degree of misconduct penalized. It should be possible to achieve a better consensus about what is fair if progress can be made on reducing the complexity and better coordination of the penalties.

Although we have not reached any final recommendations at this point, we have identified several issues that should be addressed. These are grouped below according to the category of penalty involved, i.e., penalties on taxpayers, penalties relating to information returns, and penalties on bad conduct by others.

Taxpayer Penalties

Most taxpayers are subject to five basic penalties - the long-standing delinquency, negligence and fraud penalties, and the newer incorrect valuation and substantial understatement penalties. In general, these penalties are not internally coordinated. While there are five basic penalties, there are only three instances in which these penalties have been statutorily coordinated. No delinquency penalty will be assessed on the same portion of tax deficiency on which a fraud penalty is also assessed. § 6653(d). Second, the negligence penalty will not apply to the portion of the tax deficiency on which a fraud penalty has been assessed. § 6653(a)(2). And third, either the valuation overstatement or the substantial understatement penalty (but not both of them) may be assessed on the same portion of tax understatement. § 6661(b)(3). But there is no other coordination of these five penalties.

The result is that several of these penalties are imposed for the same understatement of tax. A substantial understatement penalty, negligence penalty, and delinquency penalty may apply to the same tax delinquency. Or an overvaluation penalty, negligence penalty, and delinquency penalty may apply to the same delinquency. The number of penalties that can be imposed does not change much when a fraud penalty is involved because a substantial understatement penalty (or an overvaluation penalty) and the fraud penalty can apply to the same deficiency. Furthermore, now that the fraud penalty is applied to the fraud-tainted portion of the underpayment and the negligence penalty can apply to the balance of the tax deficiency, a taxpayer can be subject to four penalties on a single tax deficiency - delinquency, negligence, fraud and substantial understatement penalties.

The rates of the basic taxpayer penalties are also uncoordinated and not readily determinable. The rates of the penalties range from 5 percent for a one-month delinquency and 25 percent for a five-month delinquency, to a 20 (or 25) % penalty for substantial understatement, to a 5% negligence penalty, to a 75% penalty on the fraud-tainted portion of a delinquency. But because both the negligence and fraud penalties have interest-based additions, it is misleading at best to speak of a 5% negligence penalty, for example. When the interest-based addition is computed, the interest-based addition may increase the total negligence penalty to an amount that is greater than the fraud penalty.

There are a number of possibilities you may wish to consider in coordinating the taxpayer penalties:

1. The valuation penalties (§§ 6659, 6659A and 6660) single out a particular form of taxpayer misconduct for special penalty impositions. Consideration should be given to whether broad based general misconduct penalties, such as the negligence, fraud and substantial understatement penalties are adequate to discourage all forms of taxpayer misconduct and noncompliance. Also valuation issues are matters of

"opinion." "Opinion" based penalties can create difficult problems for both the administrator and the taxpayer because they do not provide a clearly identifiable standard for imposition, abatement and defense.

2. The substantial understatement penalty was intended to deal with cases where the taxpayer takes an excessively aggressive position which may be overlooked in the course of the audit lottery. Accordingly, the penalty does not apply where the taxpayer's position is supported by substantial authority or is adequately disclosed. Both the degree of disclosure and the test for substantial authority are stricter than what would be required to avoid a negligence penalty, but the IRS has the right to waive the penalty if the taxpayer had reasonable cause and acted in good faith -- i.e., was not negligent. Thus, the penalty may be considered functionally to be simply an attempt to articulate more specific standards for negligence. If so it might be preferable to have one section which pulls together and integrates the rules which describe negligence rather than to have two independent sections dealing with very similar subject matter in quite different ways.

As a possible method of consolidation, Congress could provide a 5% basic negligence penalty applicable to the negligence-tainted portion of the deficiency or underpayment. The penalty could then be increased to 25% if the underpayment exceeds the greater of $5,000 or 10% of the correct tax liability. Since a fraud penalty rate is 75%, there is room for a negligence penalty of varying rates ranging from 5% to 50% of the underpayment attributable to negligence depending on the degree or form of the misconduct.

3. Another alternative is to preserve the substantial underpayment penalty as a penalty separate from negligence but to eliminate the overlap between it and the negligence and fraud penalties. Thus when the substantial understatement penalty is imposed, a taxpayer would not also be subjected to either a negligence or fraud penalty. Conversely, if either the negligence or fraud penalty is asserted with respect to portions of an underpayment, the substantial understatement penalty would also not be assessed.

4. If the "substantial authority" test is retained, either as part of a separate substantial understatement penalty or as one test under the negligence penalty, it should be reviewed to reflect present day methods of determining tax law. The definition of substantial authority contained in the regulations is very rigid and unrealistic. Authorities which are today universally used by private tax practitioners, by the IRS, and by the courts in determining the law are not given any weight whatever as a defense against the penalty. Examples are private letter rulings and the "Blue Book" explanations of legislation prepared by the staff of the Joint Committee on Taxation. Furthermore the existence of this test in the penalty section has led the IRS to propose the use of the same test in determining which practitioners are permitted to practice before it. A situation in which taxpayers are penalized and practitioners threatened for relying on research tools used by all conscientious practitioners, by the IRS and by the Supreme Court should not be allowed to continue.

5. There should be a review of the penalty rates. The interest-based or time sensitive portions of the negligence and fraud penalties should be reconsidered. During 1981 and 1982

when new penalties and time sensitive penalties were enacted, the interest provisions were also radically changed. Today, the interest rate on tax deficiencies is changed quarterly and compounded daily, largely eliminating the need for interest-based additions to penalties.

It may be preferable for penalty rates to be adjusted than for new penalties to be added to or retained in the Code. By 1981, the combination of the flat 5% negligence penalty and current simple interest at 5%, per annum (when compared to the market interest rates and inflation) was inadequate to discourage increased playing the "audit lottery" and the growth of abusive tax shelters. Congress could have approached the problem by merely increasing the rate of the negligence penalty and the interest rate. Instead, new penalties were fashioned. These include the substantial understatement penalty (§6661), the overvaluation penalties (§§6659-6660) and the various interest components of the negligence and fraud penalties, as well as the increased interest rate for tax motivated transactions. These new penalties have been responsible for some of the problems in the penalty structure we are now reviewing.

Information Return Penalties

Information reporting penalties comprise about one-third of the existing 150 penalties in the Code. While some of these penalties are consolidated in Sections 6721-6724, substantial improvement could be made in the area of information reporting penalities by three basic changes to the system.

First, the penalties should increase from a minimum to a maximum amount depending on the period of delinquency in the same manner as the delinquency penalties imposed on taxpayers by Section 6651. The existing information reporting penalties could be described as "cliff" type penalties. That is, the full amount of the penalty applies immediately on the first day an information report becomes delinquent. In this circumstance, there is no incentive for a delinquent reporter to file a late return. Late information or corrected information may be useful to the Service for some period after the due date for the filing of the report.

Second, consideration needs to be given to variation in the penalty rates depending on the "tax harm" arising from the failure to report. Thus, a distinction should be drawn between the failure to report small and large items.

Lastly, the standards for imposition and abatement of the information reporting penalties should be made uniform.

Bad Conduct Penalties

These penalties generally apply to third party conduct which instigates or cooperates in the preparation of improper returns by taxpayers. These include penalties on tax return preparers, promoters or abusive tax shelters, and tax protesters. Most of these penalties are specific reactions to widespread abuses in the tax system experienced in the 1970's and early 1980's.

The civil penalties in this class included penalties designed to apply to tax return preparers and advisors (§§ 6694, 6695, and 6696); promoters of abusive tax shelters (§ 6700); aiders and abettors of tax understatements (§ 6701); and taxpayers who file frivolous returns or Tax Court proceedings (§ 6673). Each of these penalties has been enacted since 1976 to combat a specific compliance problem too difficult to address within the then-existing penalty structure.

These provisions are relatively new, and little authority interpreting them exists. In fact, Regulations have not been issued in some instances. We are aware that concerns have been raised about the influence which the Internal Revenue Service might exert over tax practitioners through threatening imposition of these penalties and the related threat of disciplinary action by the Service or professional groups. We would expect the Subcommittee may want to satisfy itself that the provisions are producing the intended results in individual cases. As individual tax practitioners, we are clearly in the class of persons whose conduct is influenced by these penalties, and we can provide that point of view. Further, we have a few technical suggestions that can be made at the appropriate time.

Interest

Although the interest paid on a tax deficiency is not technically a penalty, we suggest the Subcommittee may want to reexamine the interrelationship of tax deficiencies, penalties, and the interest thereon. Taxpayers are likely to consider the total additions to tax, interest as well as penalties, as having a punitive intent. In that context it is unfortunate that the fact that higher interest is charged on deficiencies than is paid on refunds and the fact that interest paid is nondeductible and interest received is taxable are likely to be considered not only punitive but unfairly punitive.

Conclusion

We commend the Subcommittee for its attention to a reexamination of the Code's civil penalty structure. Voluntary compliance is at the heart of our tax system's success, and civil penalties have a role to play in achieving voluntary compliance. We stand ready to assist you in achieving a civil penalty system that is understandable, logical, and appropriate to encourage voluntary compliance and respect for our tax system.

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Chairman **Pickle**. Mr. Hall, I thank you. You have given an excellent statement. We hope when you finish your report, your recommendations will be suggested corrections, if you don't like the cliff, suggest how you might handle it.

Mr. **Hall**. Yes, sir.

Chairman **Pickle**. Your report will mean a lot to us. We will keep in touch.

Now, Mr. Charles Rau.

STATEMENT OF CHARLES W. RAU, VICE PRESIDENT, TAXES, MCI COMMUNICATIONS CORP., ON BEHALF OF THE TAX EXECUTIVES INSTITUTE, INC.

Mr. **Rau**. Thank you, Mr. Chairman. I am here in behalf of Tax Executives Institute. The Tax Executives Institute is comprised of 4,000 members, most of whom are certified public accountants, attorneys or both. Our members are not advisers to, but have the day-to-day management responsibility for the tax departments of 2,000 major corporations in North America.

As a professional organization, we are firmly committed to maintaining a tax system that is both administerable and can be complied with. In the area of penalties, I am here today to express our deep concern about a penalty system which now subjects to punishment taxpayers who make a good faith effort to comply with our increasingly uncertain and complex federal tax system.

A penalty system which may punish those who inadvertently fail to comply with a body of Federal tax law that, as referred to earlier, that experienced over 6,000 subsections being changed in less than 7 years—with more than 2,700 of those changes occurring in the Tax Reform Act of 1986 alone.

We find penalties strewn throughout various subchapters of the Internal Revenue Code with uncertainty even as to the precise number of penalties. And because of a lack of coordination of the penalty provisions, they may be applied—as previously illustrated—so that a single act gives rise to the imposition of several penalties. We also have penalties which can be disproportionately harsh when applied to specific occurrences.

Mr. Chairman, TEI believes tax penalties should only be levied for deviations from a clearly defined standard of conduct that is timely established and promulgated by the Congress or the Treasury and the IRS. The massive changes in our tax system, the bulk of the regulatory pronouncements and yet the remaining backlog of unissued relations leave sophisticated tax professionals without adequate guidance and American corporations unable to determine with certainty the tax consequences of proposed business transactions.

This uncertainty as to tax consequences is bad enough. The imposition of penalties for inadvertent failures to comply with the tax law is inconsistent with our American concepts of even-handedness and fair play. The results we fear will be disrespect for our self-assessment system and reduced, not increased tax compliance.

We have made seven preliminary recommendations for possible consideration by the subcommittee. Included in these recommendations is the refinement and strengthening of our fraud and negligence penalties and the repeal of what we still believe to be the essentially no-fault section 6661 penalty.

We also urge that the Commissioner of the IRS be required to testify before the congressional tax writing committees as to pending tax legislation addressing, one, the ability of the IRS to administer the provision; two, the estimated cost to the IRS to administer the provision; three, the ability of taxpayers to comply with the provision; and four, the estimated cost to taxpayers to comply with the provision.

We believe, Mr. Chairman, that administerability, ability to comply and the cost of doing so to both Government and the private sector should be factors in determining whether particular tax legislation merits enactment. We have also suggested organizing the penalties into broad penalty categories, having fewer of them and placing them in a single portion of the Internal Revenue Code with cross-referencing to the substantive provisions of the code where appropriate.

We believe stacking of penalties should not occur, but rather the penalty most appropriate to the proscribed conduct should apply. Its severity should relate to the degree of the taxpayer's culpability. We recommend the Internal Revenue Service publish a comprehensive revenue procedure or other document detailing by penalty category the sources of penality review within the IRS, as well as the standards the IRS will apply in determining whether penalties should be abated.

Finally, Mr. Chairman, we hope your subcommittee will also address what some refer to as the nonpenalty penalties, substantive provisions that effect a punitive result. For example, the code effectively requires large publicly held companies to overpay their estimated tax payments so as to avoid incurring penalties for underpayment. We also include in this category the very onerous COBRA provisions which deny tax deductions for the entire cost of providing health care to all employees of a corporate group if through a good faith mistake a single terminated employee is not offered continuing health coverage.

Thank you for the opportunity to present these oral comments.

[The prepared statement of Mr. Rau and a supplemental statement received subsequent to the hearing follow:]

Statement

of

Charles W. Rau
Vice President-Taxes
MCI Communications Corporation
Washington, D.C.

on behalf of

TAX EXECUTIVES INSTITUTE, INC.

on

the Civil Penalty Provisions
of the
Internal Revenue Code

before

the Subcommittee on Oversight

Committee on Ways and Means
U.S. House of Representatives

March 31, 1988

Mr. Chairman and Members of the Committee: I am Charles W. Rau, Vice President - Taxes for MCI Communications Corporation, which is headquartered here in Washington. I am here today, in my capacity as Chairman of Tax Executives Institute's Task Force on Penalties, to present the Institute's views in connection with the Subcommittee's review of the Internal Revenue Code's civil penalty provisions. I am accompanied by the Institute's Tax Counsel, Timothy McCormally. We shall be pleased to respond to any questions the Committee might have.

The Institute appreciates the opportunity to testify today and looks forward to working with the Subcommittee in bringing order to the Code's complex penalty provisions.

TEI's Perspective

Mr. Chairman, TEI comes to this hearing from a vantage point different from those of most other witnesses appearing before the Subcommittee. We represent the corporate tax community and are only tangentially involved with individual tax rules and penalties. The Institute's 4,000 members are employed by the 2,000 largest corporations in North America and are charged with the day-to-day management of their companies' tax departments. Most of our members are certified public accountants or attorneys, and many are both. As a professional organization, we are firmly committed to maintaining a tax system that works-- one that is both administrable and can be complied with.

Mr. Chairman, we wish to preface our comments by noting our growing frustration with and concern about the pace and magnitude of change in our tax laws. At the risk of seeming melodramatic, we suggest that changes to the tax code during this decade have placed our self-assessment system on the brink. Taxpayers find it increasingly difficult to discern what the law is and, consequently, to comply. This point is integrally related to the subject of this hearing -- the Code's penalty provisions. In our opinion, to impose penalties under such circumstances -- or to threaten the imposition of penalties -- is akin to rubbing salt in a wound. We believe that taxpayers who endeavor in good faith to comply with the tax laws should not be penalized.* Regrettably, however, the Code's current penalty structure gives rise to situations where such taxpayers are penalized.

In the remainder of this statement, TEI offers our comments on the specific issues raised in the Subcommittee's press release concerning this hearing.

The Philosophical Basis for Civil Tax Penalties

Mr. Chairman, in announcing this hearing the Subcommittee's press release referred to the "piece-meal" approach that had been taken in the past with respect to the penalty provisions of the Internal Revenue Code. Referring to the growth (in raw numbers and in scope) of civil tax penalties during the last decade, you yourself observed that --

> the current penalty system has become entirely too complex. In order for penalties to be effective, they must be clear to the taxpayer and easy for the IRS to administer.

TEI wholeheartedly agrees, and we support the Subcommittee's effort to develop a penalty framework that is "fairer, simpler, and easier to administer."

To achieve that goal, we must first develop a consensus on what the proper role of penalties should be in the tax system. Stated differently, the philosophical, or (if you will) moral, basis for the imposition of penalties must be identified.

Tax Executives Institute submits that the following principle should govern:

> **Civil tax penalties should be exacted only for deviation from a standard of conduct that is timely established and promulgated, either by Congress or the Treasury Department and Internal Revenue Service.**

Although the foregoing principle may seem self-evident, we suggest there is considerable merit in analyzing its different components.

First, before a penalty is asserted, there must be a clearly identified standard of conduct. That is to say, the substantive tax rules must be known and understood by both taxpayers and the IRS. Such rules should be determined in light of the relative administrative cost and burdens that taxpayers will be required to bear.

Second, the governing standard of conduct must be precisely identified in advance of the time for which deviations from the standard will give rise to the penalty. Penalties should not operate in an ex post facto manner. They should only be asserted where taxpayers could have been aware of what the operable substantive rules are, and only after taxpayers are given a reasonable amount of time to review the rules and to gather and analyze the information necessary to comply. If the standard of conduct is amorphous or ever-changing, no penalty should be imposed.

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* See H.R. Rep. No. 97-760, 97th Cong., 2d Sess. 575 (1982) (Conference Report on 1982 Act) (the purpose of section 6661 was to establish a standard that assures that "those who endeavor in good faith to fairly self-assess are not penalized"); accord Staff of the Joint Comm. on Taxation, General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982, at 218 (Dec. 31, 1982).

Third, if a penalty is to be asserted, there must be a deviation from the standard of conduct. If the prescribed standard of conduct is unknown or does not lend itself to clarity, then no penalty should be imposed. Consequently, penalties should not be imposed where the taxpayer commits no culpable act or where the taxpayer's act is not capable of being described as culpable until after it is committed.

In summary, penalties should be imposed only for deviations from a discernible and precise standard of conduct that is clearly identified in advance.

Overview of Current System

TEI believes that if the Internal Revenue Code's current penalty provisions were judged against the foregoing principle, they would be found wanting in several respects. First and foremost, we believe that the rapidity and magnitude of substantive law change in recent years has rendered it very difficult, if not impossible, to discern a clear standard of conduct with respect to some areas of the Internal Revenue Code. The lack of public hearings by the tax-writing committees on specific tax legislative proposals has, in our view, exacerbated this problem.

Mr. Chairman, 75 years ago last month the 16th Amendment--authorizing the imposition of an income tax -- was added to the Constitution. The Amendment contained but 30 words, and the ensuing income tax law of 1913 was only 16 pages long. Today, in the Amendment's diamond jubilee year, American taxpayers face a tax system that is not only unrivaled in complexity but that is ever-changing. Since 1981, tax legislation has come especially fast and furious: to say that the rapidity and magnitude of change are unparalleled is no overstatement.

For example, whereas the Tax Reform Act of 1969 affected 271 subsections of the Internal Revenue Code, the 1986 Act touched 2,704 provisions. The litany of tax changes in the 1980s is astounding: the Economic Recovery Tax Act of 1981 (ERTA) saw 483 subsections amended; the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) amended or added 530 subsections; and 1984's Deficit Reduction Act (DRA) and Retirement Equity Act (REA) of 1984 combined to change 2,289 subsections. The net effect (including the 1986 Act, but excluding the Social Security Amendments Act of 1983 as well as the tax provisions of the Omnibus Budget Reconciliation Act of 1987), therefore, is that 6,006 subsections of the Code have been changed in less than seven years! Another measure of the torrent of change is the increasing length of each successive revenue bill. For example, the total number of pages in the House, Senate, and Conference Reports (as well as the Joint Committee's General Explanation) on the 1981 tax act was approximately 1,500; with respect to the 1986 act, the sum is an astounding 5,389!*

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* In total, the committee reports and Joint Committee explanations of ERTA, TEFRA, and the Tax Reform Acts of 1984 and 1986 consumed more than 13,000 pages.

Thus, change has been piled upon change. A vast array of provisions have been enacted, revised, repealed, and in some cases reinstated within a period of a few years. The swirl of legislation has been constant and the overall result has been confusion and uncertainty -- the utter inability to know what the substantive rules are and how to comply.* To impose essentially no-fault penalties under such conditions is contrary to the American sense of fair play.

The Code's penalty provisions themselves have experienced the same explosion in number and complexity, without due regard to their potential cumulative effect. In 1975, the Internal Revenue Code contained 64 civil penalties; today, the number is more than twice that -- though there appears to be some disagreement concerning the precise number.

Not included in the total, moreover, are provisions of the Internal Revenue Code that have been characterized as "non-penalty penalties" -- that is to say, substantive provisions that operate in a clearly punitive fashion. Examples of such "non-penalty penalties" are the required overpayment of estimated taxes by large publicly held corporations (in order to avoid a "real" penalty) and the draconian denial of all health care deductions where a single employee is inadvertently not offered COBRA continuation coverage.

The cumulative effect of legislative change has been staggering -- not only for taxpayers but for the government itself. When the rules are constantly changing and becoming more complex, the resulting confusion and uncertainty threatens the very existence of our self-assessment system.

What's more, much of the tax legislation enacted in this decade has amounted to little more than delegations of authority to the Treasury and IRS. The result has been further uncertainty, in large measure because the framework that the Treasury and IRS have been given is frequently inadequate. As the Treasury and IRS struggle to glean congressional intent, as they endeavor to put "flesh" on the inchoate "bones" of recent statutory language, the world continues to turn, and taxpayers' heads continue to spin. (Even with the best efforts of the IRS and Treasury in recent months, the inventory of open regulations projects as of February 28, 1988, stands at 464 projects.) Until taxpayers know what the rules are, they cannot even begin to hope to comply with the law.

Still another facet of the problem is the delay that has occurred in enacting technical corrections to the Tax Reform Act of 1986. Not only taxpayers, but the IRS had relied on the timely enactment of corrective legislation. (Indeed, the IRS and Treasury have released several sets of temporary or proposed regulations, and even 1987 tax forms, on the assumption technical corrections would be enacted.) The decision not to include technical corrections in the 1987 budget reconciliation bill placed taxpayers -- and the government -- in an untenable limbo.

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* A litany of the Code's provisions (i) that are unduly complex, (ii) that require the application of unclear standards, or (iii) that impose excessive compliance costs (when compared both to the amount of tax revenue to be raised or to the underlying goal of the substantive legislation) would be quite long. The Code's new foreign tax credit separate limitation provisions and the uniform capitalization rules are undeniable examples of complex provisions. The second category (involving unclear or amorphous standards) includes provisions requiring "fair market value" apportionments in respect of acquisitions, the calculation of corporate earnings and profits, or determination of "commensurate (super) royalties." Provisions that impose disproportionate compliance costs encompass, again, the foreign tax credit separate limitations and the uniform capitalization rules.

That limbo continues today. The Tax Reform Act of 1986 effected massive changes in the Code and, understandably, the number of required technical corrections to that Act is quite substantial. From the appropriate rate of the section 6661 penalty to the intended scope of the passive foreign investment company provisions, from the determination of transitional levels of debt under section 864(e) to the alternative minimum tax provisions --no part of the 1986 Act was totally free of technical error and, hence, no part of the Act would be untouched by the technical correction provisions. The errors are confounding enough; the uncertainty over whether and when they will be corrected make it even more difficult for corporations to prudently conduct their business affairs.

Mr. Chairman, without certainty, taxpayers cannot conduct their business affairs with any certainty of result; without stability, they cannot hope to maintain their competitive position in today's world market. TEI is not suggesting that the substantive tax laws should remain static. Rather, we submit that, in light of the frequency and magnitude of such changes, fewer and more equitable penalty assertions are warranted.

Stated simply, in the current environment of uncertainty, penalties that are not based on taxpayer misconduct have no place. Thus, we submit it is inappropriate to assert penalties against taxpayers, acting in a non-negligent and non-fraudulent manner, for failing to abide by the Code's substantive provisions when, according to the General Accounting Office, the IRS's employees themselves have an error rate of 39 percent. We respectfully suggest that, when it comes to penalties, taxpayers should not be held, in effect, to a higher standard than the agency that is interpreting and administering the law!

The GAO study should not be viewed as an indictment of the IRS but rather as a commentary on how confusing and complex the overall system has become.* Simplicity may have been a goal of the Tax Reform Act of 1986, but that goal has clearly eluded us.

Moreover, we suggest that, in enacting penalties in recent years, Congress has placed far too little emphasis on whether a provision can have a salutary effect on taxpayer behavior. In our view, penalties should have a single goal -- to encourage compliance by punishing voluntary, rather than wholly inadvertent, deviations from the prescribed and existing standard of conduct.

Where a penalty is enacted or increased on a retroactive basis, however, it cannot promote compliance. This leads us to conclude, as a corollary to our discussion of the philosophical basis for penalties, that retroactive penalties serve no legitimate tax-policy goal and should never be enacted. We similarly believe that penalties themselves should never be enacted as a source of revenue. In our opinion, retroactive or revenue-inspired penalties place in jeopardy the moral support for both the penalty scheme and our entire self-assessment system.

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* TEI appreciates that the IRS personnel assigned to answer taxpayer requests for assistance receive only limited training. The difficulty of questions posed to such personnel, however, pales in comparison to those confronted by multinational, multidivisional business taxpayers.

In this regard, our concerns were allayed somewhat by Assistant Secretary Chapoton's recent comments -- in testimony on March 14, 1988, before the Senate Finance Oversight Subcommittee -- that penalties should not be viewed as a source of revenue in and of themselves. We urge that Congress specifically confirm this principle and that the IRS be instructed to emphasize this point in its training programs and instructions to the field.

The Contours of a Rational Penalty System

Mr. Chairman, we have devoted a significant amount of effort to summarizing the uncertainty that regrettably characterizes our substantive tax rules. We have done this because we believe an understanding of the formidable task confronting taxpayers in dealing with the tax system is essential to the development of an effective, rational system of penalties.

Once the philosophical (or moral) basis for the assertion of penalties is established, the contours of the penalty provisions themselves must be prescribed. In our view, the goal should be -- as Congress forthrightly recognized in 1982 -- the enactment of a standard that ensures that "those who endeavor in good faith to fairly self-assess are not penalized." H.R. Rep. No. 97-760, 97th Cong., 2d Sess. 575 (1982) (Conference Report on 1982 Act).

Although specific taxpayer behavior may warrant particular or targeted penalty provisions, all penalty provisions should be characterized by the following:

First, penalty provisions should be known and understandable to both taxpayers and the IRS. A natural corollary to the principle that the substantive tax rule (standard of conduct) should be known is that the operation of a penalty provision should also be clear and discernible. Taxpayers must know not only what the substantive tax law rules are, but also the requirements of the Code's administrative provisions (for example, what are the relevant disclosure provisions or the prerequisites for obtaining "reasonable cause" relief?).

Second, a penalty's severity should be appropriate to the taxpayer's culpability. Penalty provisions do not exist in a vacuum. To have a salutary effect on the tax system, a penalty must be suited to the taxpayer behavior it is intended to affect. Specifically, the "punishment" must fit the "crime." One example of the opposite is the current negligence penalty, which is imposed on the entire amount of a tax deficiency, not simply on the portion attributable to negligence. For example, if the taxpayer's total tax underpayment was $1 million and only $100 of that underpayment was attributable to negligence, the penalty would be based on the $1 million underpayment!

Another, and perhaps the most egregious, example of a disproportionate penalty is the COBRA continuation coverage requirements, which is not even characterized in the Code as a penalty. The COBRA provisions would disallow the entire deduction for employer-provided health care in response to a single inadvertent failure to provide a timely notice to an employee -- even if the failure was corrected upon discovery. (In this regard, we note that a pending technical correction would partially ameliorate the harsh effect of the COBRA provision, though even the "correction" could result in a very substantial penalty.)

Third, the circumstances in which a penalty will not be asserted, even in the face of the taxpayer's failure to abide by the prescribed standard of conduct, should be identified. In other words, the situations in which penalties will be waived, or abated, either as a matter of right or of the IRS's discretion, should be spelled out, either in the statute or implementing regulations or other guidance. In this regard, we submit that the IRS should be given discretion in applying penalties, but that discretion should not be unbridled: auditing agents and Appeals Officers should not be permitted to hold penalties over a taxpayer's head as a sort of Damoclean sword -- to be imposed if the taxpayer does not concede on the substantive issue.

Preliminary Recommendations

Mr. Chairman, TEI is in the process of preparing a detailed analysis of the Code's specific penalty provisions and of developing legislative recommendations that would adhere to the principles we have discussed today. We do not wish to prejudge the work of the Subcommittee. We do wish, however, to set forth our preliminary recommendations.

First, there should be no penalty in the absence of negligence or fraud, that is, where the taxpayer does not engage in any proscribed conduct. Consequently, the penalty for substantial understatement of income tax liability (section 6661) should be repealed.

Second, the penalties for negligence and fraud should be refined and toughened, and the definitions of culpable conduct (negligence and fraud) should be clarified, either by statute or in implementing regulations. In other words, the Code should be amended to send a very clear message: not only will taxpayer misconduct not be tolerated, but it will be severely punished.

Specifically, the level of the negligence penalty should be substantially increased, but should be based simply on an appropriately determined percentage of the amount of any deficiency attributable to negligence (not on the entire underpayment). We recommend, however, that the penalty interest provisions be repealed. We submit that the penalty interest provisions serve no compelling function other than increasing the amount of the penalty (which is accomplished much more easily by raising the level of the basic penalty); repeal of the penalty interest provisions will also make computation of the penalty easier.

The new negligence penalty should be abated where taxpayers can demonstrate the existence of reasonable cause for their position (as is the case under current law) or where they explicitly identify (adequately disclose) an item on their return. Such a waiver rule, together with the decision to tie the penalty to the amount of the deficiency attributable to negligence, should minimize the reluctance of the IRS and courts to impose the increased penalty in appropriate cases, thereby enhancing the deterrent effect of the penalty.

We also recommend that the level of the fraud penalty be substantially increased and that it should continue to be based on an appropriately determined percentage of the amount of any deficiency attributable to fraud. Similar to our recommendation concerning the negligence penalty, the penalty interest provisions should be repealed.

Third, to ensure that clear, administrable, and cost-sensitive standards of conduct (substantive rules) are being enacted, the IRS -- as the enforcement agency -- should be required to testify before both the House and Senate tax-writing committees on all tax legislation. The IRS's testimony should address (1) the ability of the IRS to administer the provision, (2) the estimated cost to the IRS of administering the provision, (3) the ability of taxpayers to comply with the provision, and (4) the estimated cost to taxpayers of complying with the provision. In addition, greater public participation in hearings on specific tax legislative proposals should be encouraged.

Fourth, all penalties should be reorganized into broad penalty categories (e.g., filing penalties), and there should be a gradation of penalties within certain groupings based on the severity of the taxpayer's infraction. This would permit the coordination of all penalties, prevent "stacking" of penalties, and facilitate the application of only the most appropriate penalty to specific conduct. The goal should be to ensure that the level of penalty turns on, among other things, how long the taxpayer's non-compliance continues (thereby providing an incentive to correct errors) and the significance of the triggering misconduct.

Fifth, all penalty provisions should be placed within a single chapter or subchapter of the Internal Revenue Code, with cross-references to and from substantive areas where appropriate. Adoption of this recommendation would, by itself, enhance taxpayer and IRS understanding of penalties.

Sixth, the IRS should publish a comprehensive revenue procedure or other document (which would be cited whenever a penalty is asserted) that details, by penalty category --

- the sources of review and assistance within the IRS for reviewing assessed penalties; and
- the standards that the IRS will apply in determining whether the penalty should be abated. (In determining whether a penalty should be waived, consideration should be given to the complexity of the tax issue, the period of time that has elapsed since the substantive provision was enacted, and whether implementing regulations have been issued; in appropriate cases, substantial compliance should give rise to a waiver of a penalty.)

Seventh, the subject of "non-penalty penalties" should be addressed. For example, we submit that Congress should recognize that the complexity of the tax laws (in conjunction with the rapidity with which they have been changed in recent years) makes it impossible for taxpayers to accurately estimate their tax liability. Consequently, corporations are faced with the choice of paying a penalty (under section 6655) for underestimating their liability or overpaying their taxes (in order to avoid the penalty). This problem could be eliminated if "large taxpayers" (which currently cannot base their estimated tax installments on their prior year's tax liability) were allowed to do so or the interest-on-overpayment provisions should be amended to pay interest to taxpayers that are effectively compelled to overpay their estimated taxes.

Similarly, we submit that the COBRA continuation coverage provisions should be amended. Specifically, we believe the statute should exact a penalty only for intentional or negligent noncompliance, and that good faith mistakes or de minimis errors should not put an employer's entire plan in jeopardy, by denying the deduction for the entire cost of providing health care to all employees within the corporate group. We also submit that explicit relief should be provided in respect of multi-employer plans and foreign health plans.

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Mr. Chairman, Tax Executives Institute appreciates the opportunity to present our preliminary views on the necessary reform of the Internal Revenue Code's civil penalty provisions. We look forward to working with the Subcommittee in the development of remedial legislation and would be pleased to respond to any questions you or other members of the Subcommittee might have.

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Comments

of

TAX EXECUTIVES INSTITUTE, INC.

on

"A Philosophy of Civil Tax Penalties" Prepared by the Executive Task Force for the Commissioner's Penalty Study

August 31, 1988

On June 8, 1988, the Internal Revenue Service released for public comment a discussion draft entitled "A Philosophy of Civil Tax Penalties" which had been prepared by the Executive Task Force for the Commissioner's Penalty Study. In the transmittal letter, the chair of the Executive Task Force wrote that arriving at a consensus concerning "the philosophy and criteria that penalties should conform to is paramount in determining whether deficiencies exist in the current structure or administration of penalties."

Tax Executives Institute agrees that in order to achieve a penalty framework that is "fairer, simpler, and easier to administer," the first step is to develop a consensus on what the proper role of penalties should be in the tax system. We commend the IRS Task Force seeking to establish a credible framework for further consideration of the penalty area. We pledge to cooperate in this effort, especially as it relates to the business tax community.

In this regard, on April 5, 1988, TEI filed a position paper with the IRS in which we offered our preliminary thoughts on the proper philosophical basis for civil tax penalties. That submission, which also contained our recommendations concerning the structure and administration of the penalty system,[1] anticipated the issuance of the Task Force's Report when it asserted that "the philosophical, or (if you will) moral, basis for the imposition of penalties" had to be identified if the inquiry was to be successful.

In the comments that follow, TEI offers its reactions to the report of the IRS Task Force.[2] Specifically, we discuss the extent to which we believe the Institute's views on the philosophical tenets that must underlie the penalty system are consistent not only with those of the IRS Task Force but also with those set forth in the July 28, 1988, report of the Section of Taxation of the American Bar Association.[3] By discussing the similarities among the three reports as well as their differences, we hope to contribute to the emergence of a consensus for the development of a rational penalty system. We also discuss why adherence to uniform principles of fairness and simplicity mandates that many of the Internal Revenue Code's civil penalty provisions should be substantially modified or repealed outright.

I. Background

Tax Executives Institute approaches the subject of the Code's penalty provisions from a vantage point different from those of other organizations of tax professionals. We represent the corporate tax community and are only tangentially involved with individual tax rules and penalties. The Institute's

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[1] The recommendations encompassed both statutory and regulatory changes, as well as revisions to existing administrative procedures.

We would be pleased, upon request, to provide the IRS Task Force with additional copies of our April submission.

[2] For simplicity's sake, the Executive Task Force is referred to in these comments as "the IRS Task Force" or simply "the Task Force." Unless otherwise noted, page references are to the typewritten version of the report of the IRS Task Force.

[3] The report of the ABA Section of Taxation, which is captioned "Penalties Study Report," was prepared by a Penalties Task Force whose members were drawn from the Section's Committee on Civil and Criminal Penalties and its Committee on Administrative Practice. In these comments, the report is referred to as "ABA Report."

4,300 members are employed by the 2,000 largest corporations in North America and are charged with the day-to-day management of their companies' tax departments. Most of our members are certified public accountants or attorneys, or both.

TEI represents a cross-section of the business community, and is dedicated to the development and implementation of sound tax policy, to promoting the uniform and equitable enforcement of the tax laws, and to reducing the cost and burden of administration and compliance to the benefit of taxpayers and government alike. As a professional organization, we are firmly committed to maintaining a tax system that works -- one that is both administrable and with which taxpayers can comply.

II. Definition of a Civil Tax Penalty

The IRS Task Force defined the term penalty as "an adverse consequence imposed on a person for failure to comply with a federal tax rule." (Page 3.) As far as it goes, this proffered definition is unassailable: clearly, a penalty should not be imposed unless the taxpayer fails to comply with a federal tax rule. The definition, however, may be misconstrued to suggest that -- in applying the Code's penalty provisions -- there are only two types of taxpayers: compliant and noncompliant.

Although such a bifurcation has obvious appeal, we submit it accords insufficient weight to the level of uncertainty that currently exists with respect to what the existing "federal tax rules" are. It is for this reason that TEI argued in its April submission that civil tax penalties --

> "should be exacted only for deviation from a clearly defined standard of conduct that is timely established and promulgated, either by Congress or the Treasury Department and Internal Revenue Service."

Stated differently, TEI believes that the Task Force's definition should be revised to take into account that the substantive tax rules are not always well known and, consequently, compliance or noncompliance is not always the choice that confronts the taxpayer. We agree that penalties, which are imposed for violating substantive rules, must be viewed separately from the substantive rules themselves. We suggest, however, that before a penalty assertion can be justified, the pertinent federal tax rule must be known or at least "knowable" (*i.e.*, subject to reasonable interpretation by a prudent person).[4]

We submit, moreover, that this issue is fundamentally one of definition (rather than administration). That is to say, the operative definition should give weight to the concept of culpability. The definitional act -- the somewhat facile division of the world into "good" (compliant) and "bad" (noncompliant) taxpayers -- should not sanction the imposition of penalties where the underlying law is unclear.[5] As the ABA Report suggests, the inquiry should be whether a taxpayer is at fault for not knowing what the law is. (ABA Report, at page 34.)

III. The Purposes of Civil Tax Penalties

In our April comments, TEI stated that penalties should have a single goal -- to encourage compliance by punishing voluntary, as distinct from inadvertent, deviations from the prescribed and existing (i.e., clearly identified) standard of conduct. From this conclusion, we drew two corollaries: first, penalties should not be enacted or increased on a retroactive basis; and second, penalties themselves should never be enacted as a source of revenue. As we stated in our April comments, "retroactive or revenue-inspired penalties place in jeopardy the moral support for both the penalty scheme and our entire self-assessment system."

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[4] Thus, where there are two or more reasonable interpretations of the statute, taxpayers should not be penalized for adopting the interpretation most favorable to the determination of their tax liability, even if -- ultimately -- that interpretation is not sustained as a matter of substantive law.

[5] In this regard, we endorse the statement in the Task Force's report that "[g]iven that the purpose of penalties is not to punish the noncompliant, the fact of noncompliance is an insufficient basis for the imposition of a penalty." (Page 8.) We recommend that this thought be incorporated into the definition of a legitimate penalty.

We also recommend that in assessing whether a taxpayer's noncompliance should be subject to a penalty, consideration should be given to how long the applicable substantive rule has been outstanding. Where the underlying substantive provision is recently enacted or where the IRS has not yet issued necessary guidance, penalties should be only sparingly imposed for noncompliance. This assumes, of course, that there is a need for such administrative guidance; where the statute is clear on its face, the taxpayer's noncompliance -- even within the "grace period" -- should not merit special treatment.

We also recommended in our April comments that the following three principles should mark all penalty provisions:

First, penalty provisions should be known and understandable to both taxpayers and the IRS.

Second, a penalty's severity should be appropriate to the taxpayer's culpability.

Third, the circumstances in which a penalty will not be asserted, even in the face of the taxpayer's failure to abide by the prescribed standard of conduct, should be identified.

These principles were implicitly embraced by the subsequently released ABA Report, which concluded (at pages 12-15) that the following legal criteria should govern the adoption, interpretation, and application of penalties:

1. A penalty should reflect its limited force in preventing undesirable behavior. Penalties are not the only means to prevent conduct that threatens harm to the tax system.

2. A penalty should reflect minimum standards, not ideal conduct. A penalty that imposes too high a standard will inevitably draw into question its own legitimacy by subjecting a broad segment of taxpayers to punishment.

3. A penalty should establish a certain and not imprecise standard to give a fair warning of what is actually required.

4. A penalty statute should give an independent and reasonably complete warning of the prohibited conduct. The occasion on which a sanction is to be imposed should be reasonably free from doubt.

5. The same misconduct should not be subject to more than one penalty.

6. A penalty should serve an educational function for the affected taxpayer and taxpayers in general.

7. The punishment imposed by a penalty should correspond with the seriousness of the threat to the tax system created by the conduct involved.

TEI is pleased that the IRS Task Force has embraced principles similar to those espoused by TEI in its April comments (as well as by the ABA in its report). Specifically, the Task Force concluded that "the sole purpose of civil tax penalties should be to enhance voluntary compliance."[6] (Page 7.) In reaching this conclusion, the Task Force expressly rejected revenue raising as a proper purpose of penalties, as well as the use of penalties as a means of punishing noncompliant behavior or of reimbursing the government for the cost of its compliance program. (Page 6.)

We commend the IRS Task Force for recognizing the limits of civil tax penalties as a compliance tool. We specifically embrace the statement in the Task Force's Report that "[i]f the taxpayer is ignorant of his or her obligations and this ignorance is not the result of a failure to pay adequate attention to his affairs, imposing a penalty probably does not serve a goal of specific deterrence." (Page 8.) Thus, both penalties and the underlying substantive law must be known and understandable to the taxpayer and the IRS before noncompliance can be justifiably punished.[7]

We also believe that any evaluation of the penalty system must take into account that penalties are only one of the tools that the IRS has at its disposal to encourage compliance with the tax laws. (Page 9.) Thus, due weight should be given to the other "weapons" in the IRS's compliance "arsenal." Perhaps most important are the IRS's educational efforts, which should be directed at ensuring that the substantive tax rules -- the expected standard of behavior -- are known. In addition, the development and implementation of effective examination and collection programs should not be overlooked in an effort to rationalize the injudicious enactment or assertion of penalties.

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[6] The Task Force also stated that penalties serve to establish "norms of conduct." (Page 5.)

[7] As we stated in our April comments, all penalty provisions should be placed within a single chapter or subchapter of the Code, with cross-references to and from the substantive provisions where appropriate. The adoption of this recommendation would, by itself, enhance taxpayer and IRS understanding of penalties.

With particular regard to corporate taxpayers, the Coordinated Examination Program (CEP), which subjects certain corporate taxpayers to perpetual audit, has proven to be an effective and cost-efficient way for the IRS to deal with the complexity and resulting uncertainty that this group of taxpayers confronts on an annual basis. We would hope that one of the assumptions underlying the CEP program is that the role of TEI members and other corporate tax professionals is not to direct corporations to be noncompliant; rather, it is to minimize a corporation's tax liability, as well as its tax compliance cost, while complying with the law.

In other words, the CEP program -- even though generating substantial revenues for the IRS -- is not premised on the affected taxpayer's being intentionally noncompliant or acting in bad faith. Thus, the program acknowledges that taxpayers may -- in the words of the IRS Task Force's Report-- have "an acceptable reason for failure" (page 9) and that --

> "the appropriate enhancement of compliance may be the removal of the barrier [to compliance] rather than punishment of the noncompliant behavior." (Page 9.)

We submit that the indiscriminate wielding of the penalties sword in respect of these taxpayers -- without adequate regard for whether the applicable standard of conduct is discernible -- is not only unfair and counterproductive but also inconsistent with the stated purpose of the penalties system -- encouraging voluntary compliance.

IV. The Criteria for Evaluating Specific Penalties

From its discussion of the purposes and limitations of penalties, the IRS Task Force's Report proceeds to address the evaluation of particular penalties. Specifically, the Task Force concluded that penalties should be judged on the basis of their fairness, simplicity, administrability, and effectiveness. (Page 9.) TEI agrees that the four criteria developed by the Task Force are relevant in evaluating particular penalties. We offer the following comments with respect to each criterion.

A. Fairness. TEI is especially heartened by the Task Force's articulation of three distinct components of the fairness criterion: culpability, equity, and severity. In particular, we agree with the Task Force that --

o the quality of the taxpayer's intent in not complying should be taken into account and that taxpayer who, though noncompliant, is not compliant through "excusable ignorance" or other "excusable cause," should be penalized only if the general deterrence purpose of the penalty is sufficiently compelling (page 10); and

o a penalty for conduct that is sure to be discovered should not be as severe as a penalty for noncompliant conduct that is likely not to be discovered (page 11).

B. Simplicity. As to the simplicity criterion, TEI obviously agrees that both the substantive tax rules and applicable penalties must be "understandable and understood." (Page 11.) We similarly agree that simplicity may mean different things to different groups of taxpayers.

We must take issue, however, with the implication that corporations may properly be held to a higher standard of conduct than other taxpayers. Concededly, "[t]he practitioner or the sophisticated financial institution may be able to deal with more complexity than can many individual taxpayers." (Page 11.) Nevertheless, the substantive tax laws that corporations must contend with are exceedingly more complex than those applicable to individuals. For example, no matter how complex the individual tax rules might seem (even taking into account the passive activity loss rules), that complexity pales in comparison with the foreign tax credit separate limitation and interest allocation rules.

C. Administrability. The Task Force's Report states that "[p]enalties should be administrable and administered with reasonableness, responsiveness, and reproducibility." (Page 11.) The report continues to state that "when a rule could result in an inconsistent assertion or nonassertion [of the penalty] in a particular situation, the written rule should permit the administrator to take appropriate action." (Page 12.) The ominous implication of the statement is that in such cases the penalty should be levied.

TEI agrees that penalties should achieve reasonable results and that the concept of uniformity is certainly a meritorious one. We submit, however, that in exercising its discretion under the penalty provisions, the IRS should properly be disposed in such cases not to assert the penalty. Thus, if the literal application of the written rules would result in the non-assertion of a penalty, in no event should a taxpayer be subject to the penalty based on an administrator's judgment of what might be "appropriate." Conversely, where the taxpayer has made a good faith effort to comply (as determined under a facts-and-circumstances test), the penalty should be waived even though its assertion might be rationalized under a literal reading of the statutory provision.[8]

D. Effectiveness. As to judging the effectiveness of penalties, TEI believes it is appropriate to assert progressively more onerous penalties for continued failures to comply if such failures relate to a particular deduction, particular income item, or to a particular information reporting requirement. In this regard, we believe the Task Force's proposed "tracking system," pursuant to which a taxpayer would be minimally penalized for the initial instance of noncompliance but subject to stiffer penalties for ongoing noncompliance, merits consideration. Stiffer penalties should not be asserted, however, simply because the taxpayer was noncompliant for more than one tax period when the later infraction is not directly related to the first.

The Task Force concluded its discussion of the applicable criteria by stating that a proper analysis of the four standards should be approached on "an issue-by-issue, penalty-by-penalty basis and temptations to simplify or paint with a broad brush should be carefully considered, if not avoided entirely." (Page 13.) TEI disagrees that compliance should be approached on a targeted basis, and submits that the Task Force's proposed approach could be used to justify a further proliferation of the number and type of penalties. We suggest that the judicious application of a limited number of properly drawn penalties (such as a revised negligence penalty) to all areas of the tax law could effectively meet the four criteria listed above.

V. The Goals for Administering Penalties

The Task Force concluded that "the goals of administering the penalties have been inadequately developed." (Page 15.) In an effort to address this shortcoming, the Task Force suggested that penalties should be imposed, contested, and resolved in a manner that is responsive, reasonable and reproducible. (Page 11, 15-16.)

With respect to the goal of "reproducibility," the Task Force stated that "a particular set of facts should give rise to the same outcome, regardless of what office or individual makes the final decision." (Page 15.) TEI agrees in principle, but believes that the penalties system should lend itself to the resolution of penalty issues at the audit level. Specifically, we recommend that the IRS's Penalty Screening Committees (PSCs) should be utilized in the manner discussed in our April submission.[9] We do not believe CEP taxpayers should be forced to go to the Appeals Division to "negotiate" a proposed penalty. Nor should the Appeals Division have the authority to initially raise a proposed penalty with a taxpayer. Thus, if the examining agent in a CEP audit does not assert a penalty, the Appeals Officer should not be permitted to use the penalty as a perceived "bargaining chip."[10]

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[8] This would be consistent with Blackstone's maxim, "It is better that ten guilty persons escape than one innocent suffer."

[9] For convenience sake, the portion of our April comments relating to the operation of PSCs (pages 25-28) is attached as an appendix to these comments.

[10] See ABA Report, at page 84 (expressing concern about the potential for abuse where the assertion of a penalty is threatened during negotiations with the IRS).

VI. Discussion of Specific Penalties

Part VII of the Task Force's Report is devoted to a discussion of six major penalty groups: (i) understatement, (ii) failure to file and failure to pay, (iii) information returns, (iv) preparer, promoter, and protester, (v) exempt organization, and (vi) employee plans.

The Task Force has done a generally commendable job of identifying the major issues that need to be addressed in respect of each of these categories of penalties. We suggest, however, that in framing the issues, the Task Force frequently deviated from the philosophy and goals set forth in the first six parts of its report. Stated simply, although suggesting (albeit tentatively) certain ameliatory changes to some penalty provisions, part VII of the Task Force's Report seemingly embraces penalties that deviate from the principles that should underlie a rational penalty system.

In the comments that follow, TEI offers its reactions to the Task Force's comments on specific penalty categories. For simplicity's sake, our views generally follow the organization of the Task Force's Report.[11]

A. Negligence and Fraud Penalties. In its April comments, TEI argued that there should be no penalty in the absence of negligence or fraud -- that is, where the taxpayer does not engage in any proscribed conduct. We recommended, however, that the penalties for negligence and fraud should be refined and toughened, and the definitions of culpable conduct (negligence and fraud) should be clarified, either by statute or in implementing regulations.

We specifically urged that the level of the negligence penalty be substantially increased, but further recommended that the penalty should be based simply on an appropriately determined percentage of the amount of any deficiency attributable to negligence (*not* on the entire underpayment). Adoption of this latter recommendation would harmonize the negligence and fraud penalties and prevent situations where the assertion of a fraud penalty would result in a lower penalty than would the assertion of a negligence penalty. We also recommended that the penalty interest provisions be repealed.[12]

TEI is pleased that the IRS Task Force has recommended that consideration be given to (i) whether the interest component of the negligence penalty should be repealed; (ii) whether the negligence penalty should be targeted; and (iii) whether the rate of the negligence penalty should be increased. (Page 19.) The IRS's adoption of TEI's recommendations in this regard would contribute to the development of a rational penalty system. The Task Force also concludes that the imposition of multiple penalties for a single instance of misconduct "seems unnecessary" (page 20) -- a conclusion TEI wholeheartedly supports. *Accord* ABA Report, at pages 38-39.

In this regard, we note that the ABA Report not only supports the repeal of the interest component of the negligence penalty (ABA Report, at page 39), but is also in accord with TEI's recommendation that the negligence penalty should be asserted solely with respect to the amount attributable to negligence, and not on the entire underpayment. (ABA Report, at pages 37-38.) In addition, TEI believes that the negligence penalty should not be imposed where the taxpayer discloses his position. For example, a taxpayer should not be penalized for intentionally disregarding rules and regulations where the taxpayer reasonably believes the regulation is not supported by the underlying statutory provision *and* that position is disclosed on the appropriate income tax return. *Accord* ABA Report, at page 35.

B. Substantial Understatement Penalty. As both our April comments and the preceding discussion make clear, TEI is very much concerned about the theoretical basis for, and the application of, the substantial understatement penalty imposed by section 6661 of the Code. We have recommended that the provision be repealed, and are pleased that the ABA Report espouses a similar recommendation. (ABA Report, at pages 47-48.) Like the ABA, TEI believes that culpable taxpayer behavior can be adequately addressed by a refined negligence provision.[13]

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[11] Thus, the order in which we discuss the specific penalties should not be construed as indicative of their relative importance to the Institute.

[12] As we stated in our April comments, "the penalty interest provisions serve no compelling function other than increasing the amount of the penalty (which is accomplished much more easily by raising the level of the basic penalty); repeal of the penalty interest provisions will also make computation of the penalty easier."

Given our recommendation that section 6661 be repealed, TEI is understandably dismayed by the approach taken by the IRS Task Force toward the substantial understatement penalty. The Task Force properly frames the issue as "what behavior should be penalized" (page 16), but proceeds to suggest that the failure to disclose "aggressive positions" is behavior that should be defined as noncompliance and, hence, penalized.

TEI continues to believe that the substantial understatement penalty is flawed in concept and application. The principal question is, concededly, what behavior should be expected from taxpayers. Its answer: a good faith effort to comply with the tax laws. Consequently, taxpayers "who endeavor in good faith to fairly self-assess [should] not be penalized." H.R. Rep. No. 97-760, 97th Cong., 2d Sess. 575 (1982) (Conference Report on the Tax Equity and Fiscal Responsibility Act of 1982) (discussion of section 6661). As the ABA Report states, the penalty should "reflect minimum standards, not ideal conduct." (ABA Report, at page 12.) Hence, even though taxpayers should aspire to more than non-fraudulent, non-negligent behavior, they should not be penalized for not achieving the ideal -- the filing of a virtually "perfect" tax return.

TEI is also concerned about the disparate treatment potentially accorded equally compliant (or noncompliant) taxpayers under section 6661 because of the 10-percent threshold for application. Thus, if two taxpayers -- one with a substantial amount of taxable income and the second with a net operating loss-- misreport the identical item on their return (for the same "reasons"), only the second may be subject to the substantial understatement penalty since the amount of the item might not equal or exceed 10 percent of first taxpayer's income tax liability.[14] In view of the goal of fairness and its component "equity," we suggest that it might be appropriate to revisit, as an independent matter, the use of a percentage threshold in section 6661.

TEI also believes that proponents of section 6661 misapprehend how taxpayers (especially large corporate taxpayers such as those that TEI members represent) make return reporting decisions and how the substantial understatement penalty operates. Thus, the Task Force intimates that the penalty is asserted against taxpayers that consciously decide not to report "aggressive positions" -- those that choose to play the so-called audit lottery. For most CEP taxpayers, however, that is simply not the case. First, such taxpayers are under continual audit by the IRS and, accordingly, could not engage in the "audit lottery" even if they chose to. Perhaps more fundamentally, most of the section 6661 penalty situations with which TEI is familiar deal not with aggressive positions having been taken on the tax return, but rather with a multi-year and in-depth CEP audit uncovering facts that were unknown to the corporate tax department at the time the return was prepared.[15] Thus, the disclosure provisions afford no relief to CEP taxpayers in these situations.

As discussed in our April submission, TEI commends the IRS for adopting several of our recommendations concerning the scope of section 6661. For example, the development of Revenue Procedure 85-26, 1985-1 C.B. 580, concerning the application of the qualified amended return provisions of the section 6661 regulations to taxpayers who are subject to the coordinated examination (CEP) program, and the expansion of the "adequate disclosure" revenue procedure (currently, Revenue Procedure 88-37, 1988-30 I.R.B. 31) to include treatment of items disclosed on Schedule M-1.

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[13] We agree with the ABA Report that section 6661 was "adopted by Congress based on an incomplete, inadequate or misconceived notion of the application of the negligence penalty and its suitability to deal with taxpayers who purportedly relied on advice from tax advisers." (ABA Report, at page 48.)

[14] Indeed, the same taxpayer could find itself on either side of the penalty threshold with respect to the same item, depending on yearly fluctuations of its total income, deductions, and credits.

[15] In our April comments, we listed several particular cases in which the substantial understatement penalty has been asserted --at least at the audit level. Those situations included cases where IRS personnel have --

- o asserted a section 6661 penalty after the taxpayer discovered on audit that an error had been made in making a Schedule M-1 adjustment and disclosed it to the examiner (the taxpayer's perception being that, absent taxpayer disclosure, the agent would not have found the item); and

- o informed a taxpayer that the preparation of tax returns on the assumption that the financial books of account of a publicly traded and independently audited company were accurate was not sufficient to merit a waiver of the penalty at the audit level.

If section 6661 is to be retained, however, further recognition should be given to the special scrutiny to which CEP taxpayers are subjected. In this regard, the Task Force implied that the severity of penalties is a function of the small likelihood of an audit. (Page 19.) With respect to CEP taxpayers, however, the likelihood of an audit is quite high -- 100 percent. Consequently, consideration should be given to amending section 6661 to include a provision such as the following (which we proffered several years ago):

> Section 6661(d). -- Provision for Regularly Examined Taxpayers.-- With respect to a taxpayer that had, at the time the return referred to in subsection (b)(2)(A) was filed, at least 10 consecutive tax years examined by the Secretary and reasonably believed that the return being filed would also be examined, the standard of "reasonable basis" shall be substituted for the requirement of "substantial authority" in subsection (b)(2)(B)(i). For purposes of this subsection, the term "reasonable basis" shall include, without limitation, the treatment of an item by the taxpayer consistent with treatment found to be appropriate during a prior examination by the Secretary, absent a change in the applicable statute.[16]

Indeed, inasmuch as continually audited taxpayers cannot play the so-called audit lottery, we submit there is merit in the proposal to exclude such taxpayers from section 6661's reach altogether.

Even apart from a statutory change, we recommend that the IRS accord due weight to the enormous compliance burden faced by corporate taxpayers as well as to the manner in which corporate tax departments operate. Specifically, any determination of the taxpayer's reasonable belief (see page 18) should relate directly to the corporate tax department or, in the event outside tax advisers are used, to the management of the corporation who is in communication with such outside tax advisers. As then-Commissioner Egger assured TEI during the Institute's April 13, 1983, liaison meeting with senior National Office representatives:

> "[T]he substantial understatement penalty is not aimed at companies acting in good faith, . . . TEI members will encounter far less trouble with the provision than they might think.
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> * * *
>
> ". . . [T]he burden imposed by section 6661 is great and . . . the corporate tax department must be able to rely on the company's internal controls. The issue . . . goes to the taxpayer's good faith. If a taxpayer follows its normal procedures but there is a 'glitch,' the penalty should not be imposed. In those cases, there should be a waiver."[17]

Thus, where the company has established reasonable controls and has made a good faith effort to comply, the tax department's lack of knowledge with respect to certain facts should not give rise to the substantial understatement penalty.

Finally, we recommend that, if the substantial understatement penalty is retained, the recommendations set forth in our April submission with respect to (i) the waiver of the penalty, (ii) the definition of substantial authority, and (iii) the scope of the adequate disclosure provision be adopted. We note that our recommendations generally accord with the alternatives set forth in the ABA Task Force. (ABA Report, at pages 49-51.)

C. Information Return Penalties. In recent years, the information reporting requirements imposed by the tax law have grown enormously. Because of the scope of these rules and the corresponding number of opportunities for inadvertent -- if not unavoidable -- noncompliance, TEI believes it is important for the attendant penalties for noncompliance to be reevaluated.

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[16] The adoption of a reasonable cause standard in such cases would be consistent with the Task Force's statement (at page 10) of "excusable cause."

[17] A more comprehensive quotation from the approved minutes of the 1983 liaison meeting is set forth in our April submission.

Specifically, TEI agrees with the IRS Task Force that information return penalties should not unduly burden third parties nor be a mechanism of first resort in achieving compliance. (Page 20.) More fundamentally, we agree that if the taxpayer has instituted reasonable business practices to assure compliance and has made a good faith effort to comply, then any otherwise applicable penalty should be waived. Where there is an intentional determination not to comply with a known reporting requirement, of course, the assertion of penalties would be appropriate.

We similarly endorse the Task Force's statement that the penalty system should educate payers to comply voluntarily and, consequently, that first-time offenders should generally be warned rather than penalized. (Page 20.) We note, however, that the policy of not penalizing taxpayers in such situations is not being uniformly honored in the field. In this regard, we recommend that consideration be given to issuing a revenue procedure on the assertion of information return penalties, a principal goal of which should be uniformity of treatment. *Accord* ABA Report, at pages 118-19.

D. *Estimated Tax Penalty*. TEI is very concerned about the Task Force's characterization of the Code's estimated tax penalties. Specifically, the Task Force's Report states that "[w]hile denominated penalties, these additions to tax are, in reality, interest." (Page 27.) The report rationalizes its conclusion, by noting:

> "Thus, when all is said and done and the taxpayer settles an account which includes this addition to the tax, the taxpayer merely pays to the Government the amount his or her funds earned at the time they should have been paid to the Government." (Page 27.)

The Task Force also intimates that corporations should be held to a higher standard than individuals with respect to estimated taxes, and suggests that the penalty might properly be increased since the high repeat rate shows that there are taxpayers who intentionally disregard the requirement. (Page 27.)

TEI submits that, regardless of how it is calculated, the estimated tax penalty is punitive in nature. (As Shakespeare might say, a penalty called another name would be deceit.) Nomenclature aside, we believe the Task Force's characterization of the penalty as a "mere" interest charge misses the point, which is that the overwhelming complexity of the tax laws makes it virtually impossible for corporations to accurately estimate their tax liability.

Contrary to the Task Force's bald assertion that taxpayers *intentionally* disregard the estimated tax rules, the barriers to compliance are almost insurmountable. There is no doubt that corporate taxpayers are aware of their obligation to pay estimated tax. In today's climate of rapid and far-reaching change, however, the calculation of the amount to be deposited remains an obstacle.[18] This is especially the case where one set of substantive rules has an undeniable rippling effect on myriad others.

Indeed, in the current environment, so-called large corporations are faced with the unenviable choice of either subjecting themselves to a penalty (under section 6655) for underestimating their liability *or* overpaying their taxes (in order to avoid the penalty). Concededly, if a corporate taxpayer's resources were unlimited and sufficient time were available, the precise estimation of its tax liability would be possible. Neither condition, however, is present. In this regard, we repeat our recommendation that --

(i) "large taxpayers" be permitted to base their estimated tax installments on their prior year's (or years') tax liability, *or*

(ii) the interest-on-overpayment provisions (section 6611(a)) be amended to pay interest to taxpayers that are effectively compelled to overpay their estimated taxes.

E. *Failure to Deposit Penalties*. The Task Force rightly characterized the operation of the penalty for failure to deposit taxes in a timely fashion as "draconian." (Page 28.) The penalty is not time sensitive and, thus, is the same without regard to how delinquent the taxpayer's deposit is.

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[18] The Task Force's report refers to the "high repeat rate" for the assertion of the estimated tax penalty, but offers no empirical data on the extent to which the "repeat offenders" are individual taxpayers, small corporate taxpayers, or "large corporations" (those that cannot avail themselves of the prior year's tax safe harbor).

TEI agrees that the level of the penalty should turn on how long the taxpayer's noncompliance continues (thereby providing an incentive to correct errors). Moreover, in light of the large number of failure-to-deposit penalties that are incorrectly asserted (and subsequently abated), we favor the adoption of a procedure whereby the penalty is not asserted automatically but rather the taxpayer is provided with an opportunity to explain why it should not be asserted. (*See* page 28.) Such a procedure would contribute to increased taxpayer confidence in the fairness of the system.

F. *Employee Plan Penalties*. There can be no serious doubt that the Task Force is correct in stating that the underlying law in respect of employee plans (including those relating to plan disqualification) is "exceedingly complex." (Page 30.) We also agree that the mechanical disqualification of pension plans for failure to comply with the Code's complicated provisions will harm rank-and-file workers. The specter of disqualification (as well as the assertion of applicable excise taxes and penalties for failure to comply with myriad disclosure and reporting requirements) could potentially discourage employers from maintaining such plans. (See page 30.)

We endorse the Task Force's call for the development of a less formidable system of sanctions to promote compliance with tax and labor laws relating to employee plans. Specifically, we support the proposition that targeted excise tax provisions can more properly and fairly effectuate the policies underlying the Code's employee benefit provisions. (We do recognize, however, that in extreme cases disqualification may remain an appropriate sanction.) We recommend, moreover, that in administering the employee plan provisions, due consideration should be given (as the Task Force states) to whether the taxpayer reasonably believed that the position he had taken was correct. (See page 18.) In this regard, we believe that good faith or *de minimis* errors should not place the entire plan in jeopardy.

VII. Conclusion

Tax Executives Institute appreciates the opportunity to present our views on the IRS Task Force's Report on civil tax penalties. We believe that much of the report merits support and look forward to working with the Task Force in crafting the administrative and legislative proposals necessary to develop a rational and equitable penalty system.

TEI would be pleased to respond to any questions the Task Force might have about our comments. In this regard, please do not hesitate to call Charles W. Rau, chair of TEI's Task Force on Penalties, at (202) 887-3249 or the Institute's professional staff (Timothy J. McCormally or Mary L. Fahey) at (202) 638-5601.

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Appendix:

Excerpt from TEI's April 5, 1988, Statement on the the Civil Penalty Provisions of the Internal Revenue Code

[Page 25]

2. *Utilization of Penalty Screening Committee*. Based on comments received from a number of our members, TEI questions whether Penalty Screening Committees (PSCs) are functioning appropriately in all districts. .For example, in certain districts members believe that PSCs are, in fact, not reviewing proposed section 6661 assertions. In other districts, Penalty Screening Committees are perceived as mere "rubber stamps" for proposed penalty assertions.

An additional question relates to whether PSCs should review only situations where a penalty is proposed to be asserted or

[Page 26]

whether their role includes reviewing cases where the section's mathematical threshold is surpassed but the revenue agent (auditor) concludes that no penalty should be asserted. As a fundamental matter, TEI believes that the non-assertion of section 6661 penalties should *not* be reviewed by PSCs in order to avoid implied pressure to justify non-application or, more to the point, to assert the penalty in such cases. Routine quality control measures, however, would continue to be appropriate.

The stage during the audit at which a possible section 6661 penalty is forwarded to the PSC, as well as the development of the legal and factual facets of the automatic (by operation of statute) and discretionary waiver of the penalty, also seems to differ by district. To minimize confusion and facilitate the uniform application of National Office policy concerning the penalty, TEI recommends that the following procedure be implemented with respect to CEP audits in all districts.

- At the point during the audit when the Coordinating Agent determines that the section 6661 dollar threshold may be crossed and the Coordinating Agent tentatively concludes that the penalty may apply, the taxpayer should be given an Information Document Request (IDR) (Form 4564) that affords the taxpayer an opportunity to provide its rationale (as well as supporting authorities) for why the penalty should not be asserted. The taxpayer should be given a reasonable amount of time (say, 30 days) to respond to the IDR.

- Following receipt of the taxpayer's response to the IDR, the Coordinating Agent, with the

[Page 27]

  approval of the Case Manager, should prepare a report to the PSC. A copy of the report should be provided to the taxpayer.

- The taxpayer should be given up to 30 days to submit a written response to the Coordinating Agent/Case Manager's report, which should be forwarded to the PSC. (Ideally, the Coordinating Agent/Case Manager's report and the taxpayer's response should be simultaneously provided to the PSC.)

- The PSC should make a decision whether the section 6661 penalty should be asserted. The Coordinating Agent/Case Manager, however, should retain authority not to assert the penalty, notwithstanding the PSC's decision.

Adoption of the foregoing procedure would standardize the handling of proposed section 6661 assessments in respect of all CEP taxpayers, thereby aiding uniformity of treatment. It would also permit more detailed development of the sometimes complex factual and legal questions attendant to a proposed CEP penalty at the audit stage and subject the matter to PSC scrutiny before the penalty is asserted by the IRS. Thus, adoption of the procedure would assure that issues relating to the possible existence of substantial authority, adequate disclosure, and the discretionary waiver of the penalty are more fully reviewed at the audit level. It would also permit a taxpayer to present its views on the applicability of the discretionary waiver to the PSC. Finally, it would avoid situations of possible intimidation of taxpayers by revenue agents or Appeals Officers using the section 6661 penalty as a lever to induce agreement from a taxpayer on a substantive issue that would otherwise be unjustified.

[Page 28]

We also suggest that it would be appropriate for the National Office to publish standards that would be utilized by all PSCs in applying section 6661 discretionary waivers. (See Item No. 6, "Development of a Penalties Revenue Procedure," below.)

Chairman Pickle. Thank you, Mr. Rau. Good statement.

Now we will hear from Mr. Louis Mirman, representing the National Society of Public Accountants.

STATEMENT OF LOUIS MIRMAN, PAST PRESIDENT, NATIONAL SOCIETY OF PUBLIC ACCOUNTANTS

Mr. Mirman. Thank you, Mr. Chairman. It is a pleasure to testify today before the House Ways and Means Subcommittee on Oversight. My name is Louis Mirman and I am here to testify for the National Society of Public Accountants on the topic of reforming tax penalties of the Internal Revenue Code.

I am an independent accountant from Virginia Beach, VA, enrolled to practice before the Internal Revenue Service. I am a past president of the National Society of Public Accountants.

The services which I provide my clients are fairly typical of the other 22,000 members of NSPA who, for the most part, are sole practitioners or partners in moderately sized public accounting firms. NSPA members provide accounting, auditing, tax preparation, tax planning, financial planning and management advisory services to 4 million individuals in small business communities. I am pleased to inform the subcommittee that NSPA's testimony has the support of the Small Business Legislative Council, of which NSPA is a member.

SPGC is a permanent independent coalition of 90 trade and professional associations that share a common commitment to the future of small business. The National Society of Accountants applauds you, Mr. Chairman, and the other subcommittee members for conducting the hearings on a timely topic of immense importance to American taxpayers and practitioners.

NSPA firmly supports the desire of this committee to conduct a comprehensive review of the Internal Revenue Code penalty provisions. In a paper released to the Commissioner's Advisory Group in December 1986, the IRS stated that the Federal Government assessed 22 million penalties for a total of $5.7 billion.

Fiscal year ending September 30, 1985, the Service also reported that 4.5 million penalties were abated that year for a total of $2.6 billion. The IRS reported in the same paper that 19.8 million penalties were computer generated in fiscal year 1985, which amounted to $3.8 billion.

The society believes that these statistics highlight the tax penalty problem. First, these statistics show there is a problem with the accuracy of penalty assessments, as indicated by the fact that $2.6 billion of tax penalties were ultimately abated for fiscal year 1985. In terms of total dollars assessed, this means that 45.6 percent of all penalties assessed during fiscal year 1985 were computer-generated.

I would like to point out, Mr. Chairman, there are a lot more penalties that have not been abated because they are so small that the taxpayer refuses to fight them; therefore, the taxpayer pays them. The national society also believes that the current system of tax penalties is not accomplishing its primary objective, which is generally considered to be the promotion of increased tax compliance and deterrence.

Instead, the current IRS procedures have only touched the surface of the noncompliance dilemma. There are other areas such as the cash economy, which the IRS administrative procedures are not reaching, as there is currently no effective way of tracing such funds. Quite naturally, the members of NSPA are particularly concerned about the penalties imposed on tax return preparers.

Under the Internal Revenue Code, penalties are generally imposed on preparers due to acts of negligence, willful neglect or intentional disregard of rules or regulations. However, misapplication of the preparer penalties by the IRS, and it does happen, could lead to a breakdown in the practitioner/IRS working relationship, without which any lack of emphasis, is so very important to the tax compliance system.

For purposes of the subcommittee investigations, NSPA recommends that an attempt be made to combine and simplify the various penalty provisions under the Tax Code. Overlapping penalties or inconsistencies in enforcement of such penalties should be eliminated. Moreover, I must emphasize that the trend towards using penalties as revenue-raisers must be immediately stopped.

The national society strongly recommends that the Congress and the IRS conduct a media campaign to educate the public about the importance of tax compliance. There should be an emphasis on those civil penalties which are designed to address a taxpayer's failure to file or his or her failure to report income.

The public should be educated and made aware of the consequences of noncompliance. Efforts must also be made to eliminate inconsistencies in the application of the reasonable cause, negligence and wilfullness standards contained within the penalty provisions themselves. This is especially important in the area of preparer penalties.

In particular, penalties should not be imposed which involve areas of the tax law where no regulations or technical guidance exists, which is in existence right now with this law, or where there is no clear trend with respect to court decisions. Moreover, this is particularly a problem for the IRS and practitioners when faced with implementation of the 1986 and 1987 tax acts.

Reform of the current tax penalty provisions of the tax code is an extremely arduous task. NSPA commends this subcommittee for conducting an investigation into such an important matter for the American public and tax practitioners.

The national society stands ready to discuss any of the society's recommendations contained in this testimony. Thank you, Mr. Chairman, for inviting NSPA to testify at this most important hearing.

[The statement of Mr. Mirman follows:]

STATEMENT OF THE NATIONAL SOCIETY OF PUBLIC ACCOUNTANTS

Introduction

It is a pleasure to testify today before the House Ways and Means Subcommittee on Oversight. My name is Louis Mirman and I am here to testify for the National Society of Public Accountants (NSPA) regarding the structure of the civil penalty provisions contained in the Internal Revenue Code.

I am an independent accountant from Virginia Beach, Virginia and enrolled to practice before the Internal Revenue Service. Moreover, I am a past president of the National Society of Public Accountants.

The services which I provide my clients are fairly typical of the other 22,000 members of NSPA, who for the most part are sole practitioners or partners in moderately sized public accounting firms. NSPA members provide accounting, auditing, tax preparation, tax planning, financial planning and management advisory services to 4 million individuals and small business clients.

I am pleased to inform the subcommittee that NSPA's testimony has the support of the Small Business Legislative Council (SBLC), of which NSPA is a member. SBLC is a permanent, independent coalition of ninety trade and professional associations that share a common commitment to the future of small business. The membership of SBLC represents the interests of several million small businesses in manufacturing, retailing, distribution, professional and technical services, construction and agriculture.

The Scope of the Subcommittee's Investigation

The National Society applauds the subcommittee for conducting this hearing on a timely topic of immense importance to American taxpayers and tax practitioners. In a press release announcing this hearing, Chairman J.J. Pickle stated that "Over the years, numerous penalties have been added to the Code as part of various Revenue Acts. This piece-meal legislation, however, has resulted in a complex penalty system that is often difficult for the IRS to administer and for the taxpayer to comprehend." NSPA firmly supports the desire of this subcommittee to conduct a comprehensive review of Internal Revenue Code penalty provisions.

As a professional society representing independent accountants and tax practitioners, the National Society fully appreciates that penalties are necessary to the tax collection process. Penalties are important to encourage orderly compliance with the tax law and regulations. However, they should not be utilized as an alternative revenue source for purposes of the Federal budget process.

The tax law has become exceedingly complex and extensive. The penalty provisions of the Tax Code have also become complex and have increased substantially. This has resulted in difficulty for practitioners and a virtual impossibility for taxpayers to keep current with the changes in the law.

It is the position of NSPA that the penalty process is important for purposes of educating the American public about (1) the need to file, and (2) the proper reporting of income. On the other hand, the National Society firmly believes that the system should not penalize the taxpayer who acts in a responsible manner and makes every good faith effort possible to properly report income and pay Federal taxes.

In addition, penalties that are improperly imposed often have a negative influence on taxpayers and therefore, serve to foster a frustation on the part of the tax paying public. This type of situation often encourages a "get even" attitude among the public, resulting in non-compliance or the under-reporting of income. For these types of taxpayers, they rationalize that their actions are justified when measured against the penalty which they feel has been unjustly imposed.

A Statistical Analysis of the Penalty Provisions

In a paper released to the Commissioner's Advisory Group in December 1986, the IRS stated that the Federal government assessed 22 million penalties for a total of $5.7 billion for fiscal year ending September 30, 1985. The Service also reported 4.5 million penalties were abated that year for a total of $2.6 billion. Further, the IRS reported in the same paper that 19.8 million penalties were computer generated in fiscal year 1985, which amounted to $3.8 billion.

The Society believes that these statistics highlight the tax penalty problem. First, these statistics show that there is a problem with the accuracy of penalty assessments, as indicated by the fact that $2.6 billion of tax penalties were ultimately abated for fiscal year 1985. In terms of total dollars assessed, this means that 45.6% of all penalties were ultimately abated that year*. Second, 90% of all penalties assessed during fiscal year 1985 were computer generated.

This fact might be the underlying reason that so many penalties are ultimately abated. These statistics may also indicate that the Service needs to adjust its assessment criteria. Third, some taxpayers will pay the penalty even if it would have been abated had the administrative appeal procedure been undertaken. This means that the Federal government has unfairly and illegally taken money from citizens and other taxpayers.

Highlighting Problems With the Penalty Provisions

With approximately 150 penalty provisions in the Internal Revenue Code, it is very difficult to delineate every problem that might arise from the current penalty provisions for American taxpayers. However, as a broad policy position, the National Society recommends that Congress review the following civil penalties or penalty categories:

1. The preparer penalties under the Tax Code;
2. Federal tax deposit and other payroll tax penalties;
3. The Section 6661 penalty for substantial understatement of liability;
4. Estimated tax penalties;
5. Failure to pay penalties;
6. Delinquency (failure to file) penalties;
7. Penalties pertaining to filing Form 1099, information returns; AND
8. The Section 6672 (100%) penalty, involving the failure to collect and pay over tax or the attempt to evade or defeat tax.

We would like to highlight with some examples, problems with various penalties under the Tax Code.

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* The 1986 IRS Annual Report (Table 14) indicates that 50.7% of all penalties (in terms of total dollars) were abated in fiscal 1986; an even higher figure than fiscal 1985.

These examples should not be considered an exhaustive list; but instead, they should be considered illustrative of the predicament which many taxpayers encounter when faced with a potential penalty assessment by the Service.

One particular problem involves the filing of Form 1099, information returns and the cross-matching of such forms by the Internal Revenue Service. NSPA appreciates the importance of the cross-matching program as a means of uncovering unreported income by taxpayers. Nevertheless, the National Society believes that the cross-matching program does not truly get to the heart of the non-compliance issue.

Under Section 6721(a) of the Code, an inadvertant failure to file an information return is generally treated in the same fashion as a late filing of a similar return. Should a taxpayer not file the Form 1099 at all under these circumstances, the possibility of the taxpayer "getting caught" and being assessed a $50 penalty for failure to file is probably very low. On the other hand, if the taxpayer files the information return late, the IRS will assess a $50 penalty against that taxpayer.

Independent accountants would invariably recommend to their client that he or she file the information return late, even if it means being subject to the $50 penalty of Section 6721(a). Putting aside the benefit of such constructive advice from a tax practitioner, the National Society believes that the cross-matching program is an excellent example of a situation where the IRS is catching the very people (who for the most part) are in good faith attempting to comply with the law; and not catching those persons who may have not filed an information return at all.

The National Society also believes that the current system of tax penalties is not accomplishing its primary objective, which is generally considered to be the promotion of increased tax compliance and deterrence. Instead, the current IRS procedures have only touched the surface of the non-compliance dilemma. There are other areas such as the "cash economy", which the IRS administrative procedures are not reaching as there is currently no effective way of tracing such funds.

Another example of a source of confusion for taxpayers is with respect to the reasonable cause exception under the tax penalty provisions of the Code. In general, a significant number of civil penalties are not imposed under the Code if the failure to comply with the tax law was due to reasonable cause and not to willful neglect. The reasonable cause exception (to various penalty provisions) is a subject which there is not uniform application under the law. Many taxpayers are confused as to the application or nonapplication of this exception itself. Much of this ambiguity or lack of uniformity is probably due in part to the high degree of computer generation of the penalties themselves.

Quite naturally, the members of NSPA are particularly concerned about the penalties imposed on tax return preparers. In general, these penalties were added to the Code by the Tax Reform Act of 1976 to regulate the conduct of unscrupulous preparers. Under the Internal Revenue Code, penalties are generally imposed on preparers due to acts of negligence, willful neglect, or intentional disregard of rules or regulations. However, missapplication of the preparer penalties by the Internal Revenue Service (and it does happen) could lead to a breakdown in the practitioner/IRS working relationship; which, without any lack of emphasis, is so very important to the tax compliance process.

Recommendations

The complexity of the tax law and regulations has become a well published fact in recent years. Since 1981, there have been 5 tax bills signed into law by President Reagan. The passage of each tax act necessitates further technical corrections acts and the promulgation of additional IRS regulations. Effectively, the process has become unwieldly.

Under the guise of better enforcement of the law, 150 penalties have been included in the Tax Code to ensure compliance with this overburdened process. This Senate subcommittee hearing has been designed to bring reason back to the process. NSPA applauds this effort.

For purposes of the Subcommittee investigation, NSPA recommends that an attempt be made to combine and simplify the various penalty provisions under the Tax Code. Overlapping penalties or inconsistencies in enforcement of such penalties should be eliminated. Moreover, the trend towards using penalties as revenue raisers must be immediately stopped.

In order to improve compliance and enforcement, efforts must be made to encourage a more uniform application of the penalties themselves. This means that serious consideration should be given to the issue of whether penalties subject to a review committee are inherently more fair than those generated by a computer. The high degree of penalty abatements dramatically exemplifies the problem. More specifically, the ambiguity of when penalties apply and when they are imposed, should be eliminated.

It is the recommendation of NSPA that the Congress and the IRS conduct a media campaign to educate the public about the importance of tax compliance. There should be an emphasis on those civil penalties which are designed to address a taxpayer's failure to file or his or her failure to report income. The public should be educated and made aware of the consequences of non-compliance.

Inconsistencies in the application of the reasonable cause, negligence and willfulness standards of the Code's penalty provisions should be eliminated. This is especially important in the area of preparer penalties. In particular, penalties should not be imposed which involve areas of the tax law where no regulations, technical guidance, or technical corrections exist; or where there is no clear trend with respect to court decisions.

With the constant changes in the tax law in recent years, many dead wood provisions remain in the Code, even though inoperative. For example, to the extent the matter of tax shelter abuses and deductions are becoming a non-issue, the duplicative and unnecessary penalties underlying the tax shelter area could be eliminated.

The National Society recognizes that reform of the current tax penalty provisions of the Code is an extremely arduous task. For that reason, NSPA commends the subcommittee for conducting this investigation into such an important matter for the American public and tax practitioners. NSPA stands ready to discuss any of the Society's recommendations contained in this testimony. Thank you very much for inviting NSPA to testify at this most important hearing.

Chairman PICKLE. Thank you.

Now Mr. Donald H. Skadden, vice president of the Federal Taxation Executive Committee, American Institute of Certified Public Accountants.

STATEMENT OF DONALD H. SKADDEN, VICE PRESIDENT-TAXATION, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS [AICPA], ON BEHALF OF HERBERT J. LERNER, CHAIRMAN, FEDERAL TAXATION EXECUTIVE COMMITTEE, AICPA

Mr. SKADDEN. I am testifying on behalf of Mr. Lerner. I am vice president-taxation of the AICPA.

Since you have our full report, and in the interest of saving time, I will discuss two items I have not heard mentioned this morning, and then identify four areas of particular concern.

Chairman PICKLE. All your statements will be included in the record in their entirety.

Mr. SKADDEN. We think it is worth considering the relative impact of examinations and penalties in encouraging taxpayer compliance. With many taxpayers the desire to avoid examination is probably a stronger motivation for compliance than is the complex penalty structure in place now.

As the IRS develops more sophisticated techniques and more efficient ways to conduct examinations, it may be that some penalities will be no longer be necessary, or at least can be made less severe.

We have a new task force addressing this situation, and it is in the process of surveying our CPA tax practitioners for their views as to the administerability of the penalty system. We are also looking at what we think is a fairly novel approach to the problem. We may find it unworkable, but we are going to take a hard look at it. We plan to explore the feasibility of separating the infraction from the penalty.

It may well be that there are many infractions that should be penalized, but it does not necessarily follow that every one of those infractions has to have its own separately defined penalty. We would like to investigate a system where there would be a small number of penalties, perhaps, 5 or 10. Then, for any infraction the Congress finds deserving of punishment, it could simply select the penalty appropriate for the severity of infraction. We think this would be a tremendous source of simplification.

Some of our particular areas of concern which have already been mentioned this morning are: multiple penalties for a single infraction: computer generated penalties; penalties far in excess of the severity of the infraction; and some misuses of preparer penalties.

We are all working in the same direction.

Our goal is simplification of a terribly complex tax system. Our tax division will cooperate and assist in this effort in every way possible.

[The prepared statement follows:]

STATEMENT OF DONALD H. SKADDEN, VICE PRESIDENT-TAXATION, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS ON BEHALF OF HERBERT J. LERNER, CHAIRMAN, FEDERAL TAXATION, EXECUTIVE COMMITTEE

Mr. Chairman and subcommittee members, I am Donald H. Skadden, Vice President-Taxation of the American Institute of Certified Public Accountants (AICPA), I am testifying today on behalf of Herbert J. Lerner, Chairman of the Federal Taxation Executive Committee of the AICPA. The AICPA is the national, professional organization of CPAs with more than 266,000 members in public practice, industry, government, and education. A large proportion of these members are tax practitioners who represent millions of individual and business taxpayers. Our members are therefore very concerned with tax policy and tax administration matters, and we appreciate the opportunity to provide our input to your review of the Civil Tax Penalty System of the Internal Revenue Code.

Your subcommittee is to be complimented on its recognition of civil tax penalty reform as a major priority for the Congressional tax writing committees. The Internal Revenue Service should also be commended for its early recognition of the problems and concerns with the civil tax penalty system and its prompt initiatives in this area. A critical examination of this subject is particularly timely and appropriate.

The AICPA Tax Division shares your objective of developing a simplified and more rational civil tax penalty structure. We have recently formed a Penalty Task Force to specifically address this subject. This task force will be developing detailed comments and recommendations for our Executive Committee. We will, thereafter, be prepared to present our detailed views to your subcommittee.

At this time, I would limit my comments to two areas. First, I want to identify a number of specific aspects that we would urge your subcommittee to examine as part of its review. Following that, I will briefly describe the focus and activities of the Tax Division task force.

RECOMMENDED SCOPE OF YOUR REVIEW

A basic issue which needs to be addressed very early in the review is the appropriate role of tax penalties within the tax system. While there is general agreement that the principal objective of civil tax penalties should be to promote compliance on the part of taxpayers, there is wide-spread disagreement that even a minor objective should be the raising of revenue or the reimbursement of the IRS for administrative costs of enforcement and collection. There is considerable concern that tax penalties are being increasingly viewed as an independent source of revenue. We question whether that is sound policy in the context of our complex self-assessment tax system. In this same connection, we believe that your review should also include an examination of each penalty to determine which are effective and which are ineffective in achieving the stated goal.

A second area worthy of more detailed consideration is the relative impact of examinations, as compared to penalties, in encouraging taxpayer compliance. This could well provide an avenue to significant simplification of the penalty structure. For many taxpayers, the desire to avoid examination is probably a stronger motivating influence for tax compliance than is the complex, little understood penalty structure presently in place. As the IRS develops more sophisticated techniques for selecting returns for examination and more efficient ways to conduct examinations (including expanded document matching programs) it may be concluded that some penalties are no longer necessary to promote compliance and others could be simplified and perhaps made less severe.

Many of the provisions of the Tax Reform Act of 1986, despite their complexity, were meant to eliminate abusive taxpayer behavior by applying an extensive array of limitations or repeal of tax benefits. In view of these "loophole" closings, it may be appropriate to explore whether certain penalties designed to curb abuses in those areas may now be modified or eliminated.

The severity of each penalty provision relative to the seriousness of the infraction is also an area that appears critical to any penalty study. Special attention needs to be made to the present situation where multiple penalties can be applied to a single infraction. This potentially results in an inordinately large dollar penalty and interest assessment for the infraction being sanctioned.

Penalties can also result from inadvertent or careless errors, even for a mere timing difference in the reporting of income or deductions (i.e., in a tax year in which they should not be reported). Both taxpayer and preparer penalties are more likely to occur in a period of transition to this new law. In this 1988 tax filing season, for instance, the potential for an inadvertent error is compounded by the lack of taxpayer guidance in many areas of the law enacted by the 1986 Reform Act and 1987 Revenue Act and by the lack of a technical corrections bill to correct errors and omissions.

The existence of a civil tax penalty system which is complex, confusing, uncoordinated, and often duplicative, with the punishment in some cases far out of proportion to the infraction, also has other serious implications. Implicit in the wholesale assertion of some penalties seems to be an underlying assumption of taxpayer or practitioner guilt. An example is the current information matching program in which the IRS matches income reported by third parties with income contained in the recipient taxpayer's filed tax returns. The matching program is an effective and worthy compliance tool. However, if a mismatch occurs, a presumptive negligence penalty is automatically asserted without adequate opportunity for corrective follow-up. In many instances, it is later found that the income in question was indeed reported on the return. It simply may not have been readily apparent even with adequate disclosure. So taxpayer and IRS resources have to be utilized in the penalty abatement process. For the less persistent taxpayer or preparer, payment of the penalty may be made just to avoid the administrative hassle of abatement.

Another example is the assertion of penalties in those situations in which a position taken on the tax return may be debatable but appropriate. In view of the present complex tax law, there is often no right or wrong answer on the reporting of a particular tax matter. Parties on both sides of an issue may reasonably disagree as evidenced by the number of tax disputes which are administratively appealed or resolved by the courts. The appropriateness of penalties in these situations is highly questionable.

It is also noted that at the present time the IRS is emphasizing a program of service to taxpayers, especially in light of the difficulties expected with the 1988 filing season. The recent efforts by the IRS are commendable. However, this effort to improve both taxpayer and practitioner relations may well be diluted by the wholesale assertion of what may well be perceived to be unduly harsh penalties. Perhaps inadvertent errors or first time failures, for example in the information reporting area, should be dealt with less severely than other situations.

From the standpoint of tax practitioners, there is a further implication. The ability of certain practitioners to practice before the IRS [CPAs, attorneys, and enrolled agents] is governed by the provisions of Treasury Circular 230. Treasury Circular 230 contains standards which practitioners must meet in order to retain the ability to practice before the IRS. At the present time, when a section 6661 penalty for substantial underpayment is asserted against a taxpayer, the third party preparer is automatically referred to the Director of Practice for review under Circular 230. Similarly, whenever the $100 section 6694 penalty is asserted against a preparer, the case is automatically referred to the

Director of Practice. When one considers that the mere assertion of a penalty can call into issue the practitioner's future right to practice, it is essential that the severity of the penalty be carefully matched with the seriousness of the infraction.

Another source of penalty problems is the sheer magnitude of the tax system. Millions of individuals and entities world-wide are potential subjects to be penalized by the IRS which has tens of thousands of employees. In such an environment, it is essential that penalties be structured in such a way that they can be administered equitably and even-handedly throughout the system in all geographic areas and in all economic strata. Such a structure needs well-defined penalties and infractions with uniform criteria from the standpoint of administration.

AICPA TASK FORCE PLANS

The AICPA Penalty Task Force is made up of individuals from national, regional, and local firms with representation from various parts of the country. In its endeavors, the task force will be gathering additional background and information with respect to the matter with which we are most familiar--that is, CPA experiences with the administration of penalties. The task force plans to conduct a practitioner survey which will reflect the opinions and experiences of our 20,000 Tax Division members focusing on the administrability of the penalty system. The task force will explore such issues as the clarity of statutes imposing penalties; the availability of IRS interpretive guidance on the penalty structure; and definitional and interpretive problems, particularly reasonable cause, due diligence, and negligence; in an effort to arrive at conclusions and recommendations regarding changes that might be made. In addition, the task force will determine the experience of practitioners regarding the IRS assertion, assessment, abatement, and collection of penalties. Included in this will be consideration of the consistency of penalty application by the IRS, particularly among various Districts, Service Centers, and types of penalties.

One approach our task force is exploring for the rationalization and simplification of the entire penalty structure is to analyze separately the penalty and the punishable infraction. It may well be that there are many punishable infractions, but it does not necessarily follow that each such infraction must have a separately defined penalty. It should be possible to develop a small number of penalties--perhaps five or six--of varying levels of severity and then simply identify one of them to apply to each infraction.

Finally, the task force will consider the effectiveness of the review and appeals process within the IRS; the quality control and review at District and Service Center levels; the system and procedures for taxpayer appeal; and taxpayer notification of rights regarding penalty assertions. It is expected that the task force report will cover preparer penalties and those taxpayer penalties that our survey indicates are most burdensome or are most difficult to administer fairly and uniformly. We expect to complete this project by September 30, 1988.

In conclusion, I point out that we detect a widespread expectation that with Congress, the IRS, and many private groups and individuals addressing this issue, the end results should be a meaningful improvement in an area of great concern. The AICPA will cooperate and assist in this effort in every way possible.

Chairman PICKLE. Thank you, Mr. Skadden.

Now Mr. David Silverman, representing the National Association of Enrolled Agents.

For my information who are enrolled agents?

STATEMENT OF DAVID J. SILVERMAN, MEMBER, GOVERNMENT RELATIONS COMMITTEE, NATIONAL ASSOCIATION OF ENROLLED AGENTS

Mr. SILVERMAN. They are enrolled to represent taxpayers before the IRS pursuant to Treasury Circular 230.

I am a member of the government relations committee of the National Association of Enrolled Agents.

I want to tell you, Mr. Chairman, that we anticipate that we will be able to have our full report to you with our recommendations by the end of the summer, outlining what penalty changes should be made, what should be deleted and what penalty provisions should be maintained.

This morning, however, I will limit my testimony to the four penalty areas that our clients most frequently encounter.

Philosophically, Mr. Chairman, the penalty that is most difficult to justify is the late payment penalty. This penalty which assesses a taxpayer a half a percent a month to a maximum of 25 percent, treats the inability to pay as a civil violation of the Internal Revenue Code.

The inability to pay should not be confused with the willful failure to pay. The two are separate and distinct. Penalties should be limited to violations of law.

The second penalty that I would like to discuss is the 10 percent penalty for failing to timely deposit withholding taxes. Mr. Chairman, in many instances this penalty appears to be working against the purpose for which it was enacted.

The law requires once an employer withholds $3,000 or more in taxes from his employee's pay, that he must deposit these taxes within 3 banking days from that period and transmit it to the Government. He does this by making a deposit at his local bank.

By way of example, if an employer had to deposit $10,000 on January 6, and he looked at his watch and it was 3 o'clock and the banks were closed, he has incurred a penalty. It would be foolish for him to deposit it on January 7, because it costs no extra to hold on to these funds until the end of the quarter. I believe that this penalty is really working against the provision for which it was enacted.

The National Association of Enrolled Agents strongly urges Congress to amend this code section to require the IRS to take into account a taxpayer's timely compliance record together with his efforts to correct any delinquency before this penalty is assessed.

Mr. Chairman, there is probably not a penalty that has engendered as much litigation as the 100-percent penalty for the failure by a responsible person to collect and payover withholding taxes. The IRS officers too often indiscriminately apply this penalty.

More often than not, the service has attempted to impress a trust where none exists. A more judicious use of this penalty should be standard policy.

This penalty is applied on a guilty unless proven innocent basis. In my 25 years of practice I have defended bookkeepers, the brother-in-law of a corporate officer and a shop foreman from having this penalty applied.

The National Association of Enrolled Agents recommends this code section should be amended so the burden of proof is shifted from the taxpayer to the IRS.

In conclusion, I would like to discuss code section 6404. This section which permits the Commissioner to abate an assessment of interest if the interest is attributable in whole or in part to an error or delay by an officer of the IRS in performing a ministerial act. However, the definition of a ministerial act by the Commissioner as set forth in the temporary regulations and does not consider the delay by the IRS in expeditiously completing a tax examination to be a failure to perform such a ministerial act.

Specifically, example 4 and 5 of the temporary regulations state that if a revenue agent is either sent to a training course or assigned other cases, and his supervisor decides not to reassign the agent's case, such a delay is not a failure to perform a ministerial act.

If the service does not perceive the inability to expeditiously complete a tax examination to be the failure to perform a ministerial act then the Congress should amend this code section so a ministerial act is precisely defined.

Mr. Chairman, if I could take 30 seconds or so to illustrate the stacking of penalties.

If an employer fails to deposit $10,000 in withholding tax, he is assessed a 10-percent fine. He now owes $11,000.

At the end of the quarter he is assessed a late payment penalty. If a levy is filed this half percent is accelerated to 1 percent. Since penalties are treated as an addition to the tax, interest is constantly occurring.

So he now is subject to a 25 percent late payment penalty. The taxpayer now owes $13,750. If he continues to be in a delinquent state the code permits the service to assess a 100-percent penalty for the failure by a responsible officer to payover all the taxes that he has collected.

The taxpayer now owes $27,500, and interest at a compounded rate is accruing on these penalties.

We believe it is unfair to charge a penalty two times the amount of the tax. The taxpayer would owe $30,000 on a $10,000 liability. Interest is being compounded daily.

The rate, I think, is 11 percent, and it is compounded daily. These are trust funds and someone should be penalized, but three times?

If you look at the cases that have been decided, pull out Commerce Clearing House or any tax reporting service, you will see pages upon pages of litigation in this area.

Again, on behalf of the National Association of Enrolled Agents, I would like to thank the committee for the opportunity to make our views known. We look forward to working closely with you in addressing this problem.

[The statement of Mr. Silverman follows:]

STATEMENT
by
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MEMBER
GOVERNMENT RELATIONS COMMITTEE
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ON
THE CIVIL PENALTY PROVISIONS
CONTAINED IN THE INTERNAL REVENUE CODE
MADE TO
THE HOUSE WAYS AND MEANS SUBCOMMITTEE
ON
OVERSIGHT OF THE IRS
MARCH 31, 1988

INDEX PAGE

I. General observations. 1
II. Late Payment Penalty (6651(a)(2)). 1
III. Penalty for the failure to timely deposit withholding taxes (6656(a)). 1
IV. 100% penalty for the willful failure by a responsible person to pay over tax withheld (6672). 2
V. Penalties deducted from refunds. 2
VI. Interest Abatement (6404(e)(1) 2
VII. Penalty abatement process. 2

I. General observations

It is our impression that where penalty provisions have been enacted for the willful failure to report income or for inflating deductions such penalty provisions have improved tax compliance. However, penalties that merely penalize taxpayers for failing to timely pay or file information returns have not increased compliance. These types of penalties merely extract additional tax from taxpayers who are struggling not to be buried under a blizzard of paperwork.

II. Late Payment Penalty (6651(a)(2)).

Philosophically this penalty is the most difficult to justify. This penalty treats the inability to pay as a civil violation of the Internal Revenue Code.

Charging an individual a 1/2% a month penalty up to maximum of 25% in addition to a current market rate of interest on a debt would be declared usurious by any court in the country. In fact such a lender would probably be jailed and the debt cancelled.

Treating the inability to pay as a violation of law is a throw back to a debtors' prison mentality. The inability to pay should not be confused with the willful failure to pay. The two are separate and distinct. Bankruptcy laws were enacted in response to this distinction. Penalties should be limited to violations of law.

III. Penalty for failure to timely deposit withholding taxes.(6656(a))

In many instances, the 10% penalty for failing to make a timely deposit of withholding taxes appears to be working against the purpose for which it was enacted; to insure the expeditious collection of withholding taxes. By way of example, if $ 10,000 is withheld in the period ending January 7 it must be deposited by January 10. If the deposit is not made on time a $ 1,000 penalty is incurred, beyond that it costs nothing extra to delay payment until the quarterly payroll report is filed on April 30. If April 30 falls on a Saturday the payment is not due until May 2, almost 3 months after the payment should have been made.

Once a failure to deposit penalty is incurred it costs nothing extra to delay payment until the end of the quarter. In the preceding example no provision exists for a taxpayer to cure a late deposit payment. A day late is treated the same as 2 1/2 months late. There should be some mechanism whereby a taxpayer can eliminate or reduce this type of penalty by an assertive showing that he attempted to deposit the required liability once he discovered that he inadvertently failed to make the required payment. A positive showing of a previous record of having made timely deposits should mitigate the assertion of this type of penalty. The failure to deposit penalty is one of the few failure to pay penalties that is not computed on the basis of the time value of money. It is very easy for a bookkeeper who has to make 13 deposits during a quarter to overlook a payment date by one day.

When the failure to deposit penalty is asserted against truly delinquent taxpayers, more likely than not, it ends up in the Service's uncollectable category whereas asserting this penalty where a taxpayer merely misses a deposit deadline does nothing to speed up or insure the prompt payment of withholding taxes.

We strongly urge Congress to amend this code section to require that the IRS take into account a taxpayer's timely compliance record together with his efforts to correct any delinquency before this penalty is asserted.

IV. 100% penalty for the willful failure by a responsible person to pay over tax withheld (6672)

There is probably not a penalty that has engendered as much litigation as the 100% penalty for the failure by a responsible person to collect and pay over withholding taxes. In its zeal to collect trust funds IRS Collection Officers too often indiscriminately apply this penalty. More often than not the Service has attempted to impress a trust where none exists. A more judicious use of this penalty should become standard policy.

This penalty has a history of being applied on a guilty unless proven innocent basis. This code section should be amended so the burden of proof is shifted from the taxpayer to the IRS.

V. Penalties deducted from refunds.

Where a tax refund is due and the Internal Revenue Service has incorrectly assessed a penalty IRS procedure requires that the penalty be deducted from the amount of the refund. This is done before the taxpayer has been given an opportunity to respond to the penalty notice. Trying to get the Service to refund the penalty under such circumstances takes on the aspects of "major litigation".

VI. Interest Abatement (6404(e)(1).

Pursuant to section 6404(e)(1) of the Code, the Commissioner may abate an assessment of interest on a deficiency if the interest is attributable in whole or in part to any error or delay by an officer or employee of the Service (acting in an official capacity) in performing a ministerial act. The Commissioner may also abate interest on certain payments of tax to the extent that any delay in such payment is attributable to an officer or employee being dilatory in performing a ministerial act. An error or delay is taken into account only if no significant aspect of such error or delay can be attributed to the taxpayer involved. However, the definition of a ministerial act by the Commissioner set forth in temporary regulations 301.6404 2T (b)(2) does not consider the delay by the IRS in expeditiously completing a tax examination to be a failure to perform a ministerial act.

Examples 4 and 5 of the temporary regulation state that if a revenue agent is either sent to a training course or assigned other tasks and his supervisor decides not to reassign the agent's cases such delay is not a failure to perform a ministerial act.

Code section 6404(e)(1) was enacted so that taxpayers wouldn't be charged interest in those instances where the IRS has been "dragging its feet". If the Service does not perceive the inability to expeditiously complete a tax examination to be the failure to perform a ministerial act then the Congress should amend this code section so that a ministerial act is precisely defined.

Part of the Service's mission is to conduct tax examinations and it is completely unreasonable for them not to consider that their failure to promptly complete such examinations as not being a failure to perform their mission. Taxpayers should not be penalized because of such delays.

VII. Penalty abatement process

While most assessment notices inform a taxpayer that the penalty being assessed can be abated due to reasonable cause we find that the abatement process does not function well. It has been our experience that collection agents and correspondence clerks at the Service Centers, to whom most abatement requests are made, are not familiar with the abatement process. The correspondence that we receive bears this out in that the Service's reply to our request is simply not responsive to the facts.

When denying an abatement request the Service should stop using the unresponsive phrase "your explanation does not meet our criteria of reasonable cause." Taxpayers deserve, and the National Office of the IRS should oversee that exact reasons for denying a reasonable cause request are given. Unresponsive denials only serve to transfer the matter to the PRO or appeals. Additionally, it is not unusual for a collection agent to inform a taxpayer that he has no authority to abate a penalty and that the penalty should be paid and a claim for refund filed. On a related point when a penalty has been asserted because the Internal Revenue Service misposted a payment, the misposted payment is often corrected but the penalty that had been asserted is not. Under such circumstances there should be a mandatory procedure for the concurrent removal of all penalties and interest charged.

I hope that my comments and observations will prove to be of assistance to the Committee in its examination of the penalty provisions contained in the Code.

Respectfully submitted
David J. Silverman, EA
Member,
Government Relations Committee
National Association of
Enrolled Agents

CIVPEN2.80

Chairman PICKLE. Thank you.

Now we are going to ask Mr. Al Golato, representing H&R Block, if he would give his testimony.

STATEMENT OF AL JAMES GOLATO, CORPORATE DIRECTOR OF PUBLIC AFFAIRS, H&R BLOCK, INC.

Mr. GOLATO. Mr. Chairman, and members, I am pleased to be here.

As corporate director of public affairs for H&R Block, I would like to say I am a former assistant for public affairs to three Commissioners of the IRS. Before that I was in the IRS trenches as a revenue officer, revenue agent, and criminal investigator.

On behalf of our companies, our over 45,000 competent income tax preparers, and over 10 million taxpayer clients—and these are average taxpayers representing the masses of taxpayers—the silent, mostly complying American taxpayers—we applaud the efforts of your committee to review the numerous penalty provisions of the tax laws.

I will summarize my formal statement here. We are concerned that some of the penalties are unfair and inconsistently enforced, a burden on the poor and unsophisticated, and often, to use two terms that have been used over and over again here, "pyramided" or "stacked up".

Taxpayers who lack understanding of the reasons for some of the penalties, knowledge of how the system works in order to appeal penalties, funds to retain representation to assist them when necessary, and even courage to stand up to the Internal Revenue Service when necessary, are frequently the victims of a multitude of penalties which may be assessed against them.

In recent years Congress enacted legislation on penalties, and the IRS in enforcing the penalty provisions, have strived to improve compliance by taxpayers with the tax laws. While we agree that the ultimate objective to achieve compliance is desirable, we believe the unnecessary and often unsurmountable burden placed on many taxpayers who are assessed multiple penalties, often in a wholesale and automatic way by computers, frequently for one error on the return, far outweighs the deterrent effects which results from their application.

We also pay a high and long-lasting price in the negative public relations and the loss of confidence in our tax system, the IRS, and maybe even the Congress.

In my detailed formal statement for the record of this hearing, you will notice that we have covered penalties for negligence and for substantial understatement of tax liability, the presumptive negligence penalty, the early withdrawall penalties for pension systems and IRA's, tax preparer penalties and the estimated penalty, that last one with respect to its calculations.

Our statement outlines some of our clients' unfortunate experiences with these penalties. We show many examples, outline procedural problems, and make some recommendations. I will not repeat what is in the long statement, but I will highlight just one example as an anecdotal part of this hearing's oral testimony.

A retired widow over age 65, with a limited income from interest, dividends, a small pension, and Social Security benefits, sold some stock in 1986, which had been purchased in 1935. She, therefore, had a substantial capital gain for tax year 1986.

The capital gain was properly reported on the return, but she unknowingly failed to compute and report an alternative minimum tax resulting from the capital gain deductions. The alternative minimum tax created a tax deficiency of $8,023. The Internal Revenue Service assessed interest which was $322, a penalty in the amount of $2,000, plus $80 interest thereon, for the substantial understatement of income tax and negligence penalties totaling $562. The total amount of penalties assessed was $2,649 or 33 percent of the tax deficiency. Penalties and interest together totaled $2,972 or 37 percent of her tax deficiency. The reaction of the taxpayer to the assessment of the penalty due was to immediately pay the penalty without question.

In other words, they didn't know, or she didn't know, in this particular instance, how to appeal it. Now whether intended or not, the penalty in the case of this sort only serves as a revenue raising device.

It certainly causes the taxpayer to lose confidence in our tax system and the bottom line is that public confidence is the most important ingredient to get voluntary compliance.

Thank you, Mr. Chairman.

[The statement of Mr. Golato follows:]

STATEMENT OF AL JAMES GOLATO

CORPORATE DIRECTOR OF PUBLIC AFFAIRS

H & R BLOCK, INC.

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT

WAYS AND MEANS COMMITTEE

MARCH 31, 1988

Mr. Chairman and Members:

We applaud the efforts of Congress and the Internal Revenue Service to review the numerous penalties in the federal tax laws. We are concerned that some of the penalties are unfair and inconsistently enforced, a burden on the poor and "pyramided". Taxpayers who lack understanding of the reasons for some of penalties, knowledge of how system works in order to appeal penalties, funds to retain representation to assist them, and when necessary, courage to stand up to the Internal Revenue Service, are frequently the unintended victims of the multitude of penalties which may be assessed against them.

In recent years, Congress, in enacting legislation which increases both the types and amounts of penalties which may be assessed, and the Internal Revenue Service, in enforcing the penalty provisions, have strived to increase compliance by taxpayers with the complex tax laws. While we agree that their ultimate objective to achieve compliance is desirable, we believe the unnecessary and often unsurmountable burden placed upon many taxpayers who are assessed multiple penalties, often in a wholesale and automatic fashion by computers, frequently for one error on a return far outweighs the deterrent effect which results from their application. We also pay a high and long-lasting price in the negative public relations and loss of public confidence in our tax system and the Internal Revenue Service.

PENALTIES FOR NEGLIGENCE AND FOR SUBSTANTIAL UNDERSTATEMENT OF TAX LIABILITY

Where we see the most duplication or "pyramiding" of penalties are cases where taxpayers are assessed both negligence penalties pursuant to §6653(a) and penalties for the substantial understatement of tax liability pursuant to §6661 of the Internal Revenue Code. Frequently, these penalties, in total, are excessive and unwarranted when one takes into consideration the fact that the taxpayer made no effort to intentionally understate or underpay his income tax and the fact that the taxpayer will be required to pay interest on the additional taxes due regardless of any intent or wrongful conduct on the part of the taxpayer.

The problem is intensified when you consider the fact that penalties other than the negligence penalties and penalty for the substantial understatement of tax liability may also be assessed by the Internal Revenue Service under current tax penalty provisions for the same error on a return. For example, a penalty for the failure to pay certain taxes shown on a return or required to be shown on a return (§6651 penalties) may be assessed in the same instances where the negligence penalties and/or penalties for the substantial understatement of tax liability are assessed.

The negligence penalty under §6653(a) originally provided for a penalty of 5% of the underpayment if any part of any underpayment was due to negligence or disregard of rules or regulations. Such provision is now found at §6653(a)(1)(A). The Economic Recovery Tax Act of 1981, P.L. 97-34, added what is now §6653(a)(1)(B) which provides for an additional penalty equal to 50% of the interest payable with respect to the portion of the underpayment which is attributable to negligence. The 50%-of-interest portion of the negligence penalty was made applicable for 1981 and subsequent years' returns. The Code itself does not satisfactorily define the terms "negligence" or "disregard of rules or regulations." Section 6653(a)(3) states that the term "negligence" includes any failure to make a reasonable attempt to comply with the provisions of the Code and that same subsection provides that the term "disregard" includes any careless, reckless, or intentional disregard. These definitions provide little, if any, help to the taxpayer in determining what constitutes conduct which will bring about the assessment of a negligence penalty under §6653(a) or what they must prove to obtain the abatement of the penalty.

The negligence penalty, by the very wording of the penalty provision, implies the need on the part of the Internal Revenue Service to exercise discretion in determining if the penalty is appropriate under the circumstances. From our discussions with taxpayers and from our review of copies of reports issued by the Internal Revenue Service to taxpayers, it would appear that there is no exercise of discretion by the Internal Revenue Service in quite a few cases prior to the assessment of the penalty. Taxpayers have received computer-generated examination reports which automaticall include the assessment of the negligence penalties. The taxpayers have not discussed with the Service the tax deficiency or any matters relating to the preparation of their tax returns prior to their receipt of the examination reports containing the negligence penalty assessments. In essence, therefore, the taxpayer is automatically accused of negligence or disregard of rules or regulations and the burden is placed upon the taxpayer to defend himself against such allegations.

The penalty for the substantial understatement of income tax is found in §6661 of the Internal Revenue Code of 1986. It was originally enacted as a part of the Tax Equity and Fiscal Responsibility Act of 1982, effective for returns which have a due date after calendar year 1982. Therefore, one year after the addition of the 50%-of-interest provision to the negligence penalty section of the Code, Congress added an additional penalty which may be imposed in cases where the negligence penalties (and §6651 failure to pay penalties) are also imposed. As originally enacted, the penalty provision called for a penalty of 10% of the amount of any underpayment of tax attributable to the substantial understatement. In 1986, the penalty was increased from 10% to 25%. An understatement is defined to be the excess of the amount of income tax imposed on the taxpayer for the taxable year, over the amount of tax shown on the return. A substantial understatement of income tax is deemed to exist under the Code provision if the understatement for the taxable year exceeded the greater of 10% of the tax required to be shown on the return or $5,000. Special rules are set forth in cases involving tax shelters. Section 6661(c) provides that the Secretary may waive all or any part of the penalty "on a showing by the taxpayer that there was reasonable cause for the understatement (or part thereof) and that the taxpayer acted in good faith."

OUR CLIENTS' EXPERIENCE WITH THESE PENALTIES

We have seen that a common reaction of many individuals to the receipt of an examination report regarding a certain tax year and the assessment by the Internal Revenue Service of penalties of the types described above is not to question the assessment of the penalties or the reasons therfore, but, if possible, to pay the penalties in an effort to remove an liability to the federal government. Even those who do question the penalties frequently do not understand the explanations given or their appeal rights with respect to the penalties. With the increase in the number of unwarranted penalties which may be assessed against taxpayers for innocent mistakes and the increasing penalty amounts, the problem with penalties is intensified.

With the foregoing as a background, assume that a taxpayer makes an error in the preparation of his return which results in a tax deficiency. He may be assessed a penalty pursuant to §6651 for the failure to pay tax, negligence penalties pursuant to §6653(a)(1)(A) and (B) and a penalty for the substantial understatement of income tax pursuant to §6661. Such penalties, of course, would be assessed in addition to interest assessed on the tax deficiency. Even if the taxpayer understands the penalty assessments and the reasons therefore, if he desires to appeal such penalties, he must show that (1) his failure to pay tax was due to reasonable cause and not due to willful neglect (§6651); (2) his underpayment of taxes was not due to negligence or disregard of rules or regulations (§6653 negligence penalty); and (3) there was reasonable cause for the understatement of his taxes on his return (or part thereof) and that he acted in good faith (§6661 penalty). In other words, because of one mistake on a return, he must show the existence (or the lack of the existence, as the case may be) of all of these types of conduct and/or mental states in order to obtain the abatement of the penalties. Thus, even if grounds exist for the abatement of some or all of the penalties, it is often difficult for a taxpayer to establish such grounds without the assistance of professional help. In many cases, the taxpayer is not able to afford such help, just as he or she may not have been able to afford the cost of professional tax return preparation assistance at the time the return was prepared.

The preparation of an income tax return is anything but a simple task, despite efforts toward simplification. The tax system in general is confusing to the general public. The constant changes in tax laws add to the complexity of preparing a tax return and to the understanding by individuals of the correct tax rules. This is especially true for the elderly who have experienced numerous tax code revisions and reforms and who face new and different tax situations upon retirement or other changes in their lifestyles. The tax laws, the tax changes and the forms themselves are especially confusing to the uneducated and the undereducated. The elderly are more likely to forget an item of income and the uneducated or undereducated are most likely to misunderstand the tax consequences of a certain transaction. Mathematical errors are also frequently found on tax returns. In most of these situations, there is no intent on the part of taxpayers to understate their tax liability or to underpay their taxes. They are simply honest mistakes made in the preparation of tax returns.

EXAMPLES:

To illustrate the substantial burden placed upon taxpayers by the combination of negligence penalties and penalties for the substantial understatement of income tax, I will discuss three fact situations which have been brought to my attention. In the first case, the taxpayers received certain retirement trust income during tax year 1984 and also incurred relatively small capital gain. Information concerning this income was provided to their income tax return preparer. However, the preparer, without the knowledge of the taxpayers, neglected to include the income on the 1984 return. In 1987, the taxpayers received their first notice from the Internal Revenue Service that a problem existed on the 1984 return. Their taxable income was increased by approximately $19,000 and a tax deficiency of $7,635 was determined to exist. The Internal Revenue Service charged total interest of $2,008.02, a penalty in the amount of $1,909.00 (25% of the deficiency) for the substantial understatement of tax liability pursuant to §6661, a negligence penalty in the amount of $381.80 (5% of the deficiency) pursuant to §6653(a)(1)(A) and a negligence penalty in the amount of $796.77 pursuant to §6653(a)(1)(B). The penalties alone totalled $3,087.57 or 40% of the tax deficiency. When the $2,008.02 in interest is added, the total amount of penalties and interest increases to $5,095.59, or 66.7% of the tax deficiency. In this case, the taxpayers appealed the penalties by explaining that they did not know that their preparer had made a mistake in preparing the return. The Internal Revenue Service denied their appeal and upheld the penalties, explaining that each taxpayer is responsible for the accuracy of his or her return regardless of who prepares it. Thus, the taxpayers were forced to pay $5,095.58 in penalties and interest on a tax deficiency of $7,635.00.

In another case, a retired widow over age 65 with a limited income from interest, dividends, a small pension and social security benefits, sold some stock in 1986 which had been purchased in 1935. She, therefore, had a substantial capital gain for tax year 1986. The capital gain was property reported on the return, but she unknowingly failed to compute and report and alternative minimum tax resulting from the capital gain deduction. The alternative minimum tax created a tax deficiency of $8,023.60. The Internal Revenue Service assessed interest in the amount of $322.83, a penalty in the amount of $2,005.90 (plus $80.71 interest thereon) for the substantial understatement of income tax and negligence penalties totalling $562.60. The total amount of penalties assessed was $2,649.21 or 33% of her tax deficiency. Penalties and interest together totalled $2,972.04, or 37% of her tax deficiency.

In the final case, the taxpayers also had a capital gain which was properly reported on their return. They failed to report the alternative minimum tax liability resulting from such tax preference item. The Internal Revenue Service detected the omission of the alternative minimum tax liability and sent a notice to the taxpayers. The notice was the first knowledge that the taxpayers had an error on their return. They were not aware of the alternative minimum tax consequences of their capital gain. As was the case with the retired widow, without investigating the facts to determine if cause existed for the assessment of negligence penalties, the Internal Revenue Service included on the notice negligence penalties totalling $602.96. They also reported a penalty in the amount of $1,906.75 (plus $110.80 interest thereon) for the substantial understatement of income tax. The penalties, including the interest assessed on the substantial understatement penalty, totalled $2,620.51, or 34.4% of the tax deficiency. When added to the interest assessed on the tax deficiency ($443.22), the penalties and interest assessed for the honest mistake here involved was $3,063.73, or 40% of the tax deficiency.

In each of the foregoing cases, substantial penalties were assessed for honest mistakes made on the returns. The taxpayers had not idea that the returns which were filed underreported their correct tax liability. As noted, in the first case, after consulting a tax preparer, the taxpayer did appeal the penalties, but unsuccessfully. In the latter two cases, the reaction of the taxpayers to the assessment of the penalties was to immediately pay the penalties without question. They paid the penalties because of their general fear of the Internal Revenue Service and their lack of knowledge that they had grounds for appeal. Only after they consulted with counsel did they realize that grounds for the appeal of the penalties did exist and they were able to obtain refunds of the penalties after claims for refund were filed. I am sure there are many other taxpayers who are assessed these penalties who, like the taxpayers in the latter two cases above, automatically pay the penalties but, unlike the taxpayers above, never realize that they could have been successfully appealed. Whether intended or not, the penalties in such cases only serve as revenue raising devices. Furthermore, it should be noted that the taxpayers in such cases were able to obtain funds to pay the tax deficiencies, as well as the large penalty and interest amounts. There are many other cases where the taxpayers do not have the funds to even pay the tax deficiencies, much less the substantial amounts of interest and penalties assessed as a result of their honest mistakes.

PRESUMPTIVE NEGLIGENCE PENALTY

Prior to the enactment of the Interest and Dividend Tax Compliance Act (P.L. 98-67, 8-5-85), there were no provisions in the code for specifically assessing a negligence penalty for failure to report interest, dividends, or other types of income reported on an information return, e.g. 1099s.

The Act added section 6653(g) which provided that a taxpayer who failed to include any portion of interest, dividends, or patronage dividends reported to him on an information return was subject to a negligence penalty of 5% of the underpayment plus an amount equal to 50% of the interest payable on the underpayment. This provision applied with respect to payments made after December 31, 1983.

The rationale behind this provision can be found in the conference agreement report for P.L. 98-67 which states, "the conferees believe such a presumption of negligence is proper in such cases because the taxpayer has received the income and, under present law is required to maintain books and records adequate to assure that this income is not overlooked in filing his or her income tax return." The report goes on to state that the fact that such payments are subject to information reporting justifies the further conclusion that, even if the taxpayer had not maintained adequate records, he or she did receive a reminder of the income from the payor.

Thus, beginning for returns filed for tax year 1984, the IRS automatically assesses the penalties provided for under section 6653(g) in all cases where unreported income is detected through their matching notice program.

The presumption of negligence in this case can be rebutted by the taxpayer, but only with "clear and convincing" evidence to the contrary.

It has been our experience that it is virtually impossible to have this penalty abated. According to information we have received from the IRS, while a determination of what constitutes acceptable evidence will be made on a case-by-case basis, the only evidence that seems to be acceptable, in having these penalties abated, is one of the following:

(1) The information return is not correct

(2) The payer was unable to contact the taxpayer because of a change of address, or

(3) The person preparing the return did not have the information document due to death or illness of the taxpayer or destruction of the taxpayer's residence and records by fire or other casualty.

While we agree that there are instances in which the taxpayer deliberately does not report income, this does not appear to be the case for most of our clients who are being penalized by this provision. Many, if not most, of the occurrences involve the sick and elderly who attempt to comply by reporting all of their income, but who have simply forgotten that they received the income.

The comment in the committee report regarding the fact that the information return serves as a reminder can be rebutted by the fact many of the taxpaying public simply do not understand the significance of receiving a Form 1099. Many taxpayers, being unaware of payor tax reporting requirements, believe it is simply "another" statement from.their bank, savings and loan organization, etc. and don't recognize it as a document necessary for filing their tax return.

The Tax Reform Act of 1986 expanded the section 6653(g) penalty to cover failure to report any amount shown on "any" information return. This provision applies to returns with a due date after December 31, 1986. As it takes approximately 18 to 24 months for IRS to match information documents with income reported on returns, the affect of this provision will not be felt by taxpayers until late this year or early 1989.

CONCLUSION REGARDING SEC. 6653 AND SEC. 6661 PENALTIES

In light of the foregoing, we feel that there is a substantial need for reviewing the §6653 negligence penalties and the §6661 substantial understatement penalties, their application by the Internal Revenue Service and the effects which they have upon the taxpaying public. We suggest that the burden placed upon the substantial majority of the taxpaying public who may occasionally make an error in the application of the complex tax laws to their individual tax situation far outweighs the deterrent effect of the penalties on those who purposely attempt to avoid the payment of federal taxes.

EARLY WITHDRAWAL PENALTY

While the early withdrawal penalty provided for by sections 72(t) and 72(q) are not civil penalties, they are penalties which we believe need to be addressed.

Prior to the enactment of the Tax Reform Act of 1986, the 10% early withdrawal penalty generally applied only to premature distributions from an Individual Retirement Account (IRA). The Act extended the penalty to cover premature distributions from all qualified retirement plans and annuity contracts.

The expanded coverage of the penalty reflects the belief of Congress that retirement plan funds should be saved for retirement. In theory this is true. For practical purposes, in real life situations, the across-the-board assessment of the penalty with very few exceptions, harshly penalizes those taxpayers who through no desire on their part receive distributions from their retirement plans.

Take, for example, an individual in his mid-50s whose job has been terminated and who receives a lump-sum distribution from his employer's plan. While the penalty could be avoided if the proceeds were rolled over into an IRA, for this individual it is not practical to do so. With no job in sight and his age a negative factor in obtaining new employment, he needs the money to support himself and his family. In addition to paying tax on the distribution, he also pays a 10% early withdrawal penalty.

Under pre-1987 law which, as mentioned earlier, applied only to IRA distributions, the individual making contributions to his IRA was aware of the consequences of early withdrawal at the time the contributions were made. The contribution to the plan was voluntary and the penalty was a "trade-off" for the tax advantage of the deduction. This is not the case with employer plans. Employees perceive their employer's contribution to the retirement plan as deferred compensation for their services; funds to which they have an unrestricted right when employment is terminated.

Another factor to be considered is that employees often do not understand the potential tax consequences of receiving payouts or other distributions from their retirement plans. Although employers are required to provide certain tax information to the employee at the time of the distribution, the information is often vague or written in such a manner that it is virtually impossible for the average wage earner to decipher.

We believe that Congress should take another look at these penalty provisions and modify them to take into account hardship cases and to require better disclosure by employers.

COMPLEXITY OF COMPUTATIONS FOR ESTIMATED TAX PENALTIES

From a preparer's perspective, Underpayment of Estimated Tax Form 2210 is a nightmare, especially when the taxpayer has a large underpayment and the tax paid each quarter is unequal. In many instances, this creates what we term "split-payments". This means that the amount withheld and/or estimated tax payments for each quarter must be prorated to the quarters to which the payment applies. In this situation our preparers, both new and experienced, spend 30 minutes or more preparing this one form. We have been able to alleviate this situation somewhat by creating a worksheet which the preparer uses to allocate the payments to the proper quarter. A completed Form 2210, illustrating this situation, is attached. The sample situation is one which is commonly encountered by our preparers.

Our observation is this: if experienced preparers struggle with this, how does the self-preparer cope? The answer is, of course, that either it is not prepared, or if prepared, in most cases is prepared incorrectly.

You should observe the note at the top of page 1 of Form 2210 that states that the IRS will figure the penalty. Obviously, for our clients we would prefer to figure the penalty ourselves. Not only does this give our clients the advantage of our expertise in reducing the penalty to its lowest possible amount, it also prevents the taxpayer from receiving an additional assessment after the return has been filed. As you are well aware, if we chose not to figure the penalty and told our clients that they would receive a bill for the underpayment penalty from IRS at a later date, chances are by the time the notice arrived, the caution would have been forgotten. The client would perceive that we had made an error on the return, and expect us to pay the "penalty".

While we do not view the penalty for underpayment of estimated tax as an unfair penalty, we do believe that IRS should look for a way in which to simplify the computations necessary to achieve the same or a similar result.

PREPARER PENALTIES

There is also the preparer negligence penalties assessed against tax return preparers. The penalty which we see the most is the §6694(a) penalty assessed against individual preparers for the "negligent or intentional disregard of rules and regulations." Such Section provides for a $100 preparer penalty.

Penalties may also be assessed against tax return preparers for any willful attempt by a tax return preparer to under state the tax liability of a taxpayer. Such penalty is in the amount of $500. See §6694 (b). In addition, the Internal Revenue Code imposes a civil penalty against a tax return preparer for knowingly aiding in the preparation of a return or other document that generates an understatement of tax liability (§6701. The amount of this penalty is $1,000, unless the particular return or other document relates to the tax liability of a corporation, in which case the penalty is $10,000. No negligence or willfulness penalty under §6694 can be asserted against a preparer with respect to any return or refund claimed for which an aiding and abetting penalty has been asserted. I am aware of only a few willfulness penalties asserted against H & R Block preparers and only one aiding and abetting penalty which was even threatened against an H & R Block preparer. An aiding and abetting penalty has never, to my knowledge, been assessed against an H & R Block preparer.

With regard to the preparer negligence penalties, our experience has shown that the Internal Revenue Service has exercised better discretion in the assertion of negligence penalties as the years have gone by. Although we disagree with some penalties proposed against H & R Block preparers, we do not feel that the Internal Revenue Service is presently abusing such penalties or utilizing such penalties as revenue raising device.

PROCEDURAL PROBLEMS WITH PREPARER PENALTIES

Although the number of negligence penalties asserted against H & R Block preparers are remarkably few in relation to the about 10 million income tax returns we prepare, we do *feel that there* is a problem with the manner in which the Internal Revenue Service proceeds in preparer negligence cases once the Service has determined to assert such penalties against preparers. There are certain procedural safeguards incorporated into the Internal Revenue Code and the Treasury Regulations designed to protect the tax return preparer from the wrongful assertion of preparer negligence penalties. If the IRS determines that a penalty is to be asserted against a preparer it must first send a 30-day letter to the preparer which notifies the preparer of the proposed penalties and offers him the opportunity to appeal the determination within the IRS. If the preparer responds in a timely manner to the 30-day letter, the Internal Revenue Service is prohibited from the assessment of the penalty until its determination is made final. Treasury Regulation §1.6694-2(a) (1). If the preparer does not respond in a timely manner to the 30day notice, the penalty may be assessed by the Internal Revenue Service. However, the Internal Revenue Code provides that within 30 days after the date of the assessment, the preparer may pay a minimum of 15% of the penalty amount and file a claim for refund for such amount (on Form 6118). Pursuant to §6694(c), if the preparer follows these procedures, no levy or proceeding in court for the collection of the remainder of the penalty may be made, begun, or prosecuted until the preparer has exhausted his appeal rights. If, in response to the claim for refund filed on behalf of the preparer, the claim is denied or six months have expired from the day on which the claim for refund was filed (and no action has been taken by the IRS), the preparer may initiate a proceeding in the appropriate United States District Court for the determination of his liability for the penalty. The preparer has 30 days after the date of the denial of the claim for refund or after the expiration of the six-month period to begin the proceeding in the United States District Court. If the preparer fails to do so within such 30-day period, the IRS may collect the penalty.

Our experience has shown that, in a number of cases, these procedural safeguards have been disregarded by the Internal Revenue Service. We have seen cases where penalties have been assessed against preparers where no 30-day letter was ever sent to the preparer. In recent years, penalties have been assessed against preparers on computer-generated assessment notices which do not identify the return for which the penalty has been assessed and which provide no explanation for the assessment of the penalty. We have frequently been unable to obtain the necessary information to properly prepare a claim for refund within the 30-day period allowed by §6694(c). The biggest problem however, has been the assessment of the penalty after the preparer has filed a timely response to a 30-day letter. In some cases, the Internal Revenue Service has contended that the assessment was necessary due to the impending expiration of the applicable statute of limitations. However, by its own internal procedures the assessment of the penalty in such circumstances is no longer necessary by the Internal Revenue Service. Since at least 1983, the Internal Revenue Service has had available for its use the form 872-D, Consent to Extend the Time on Assessment of Tax Return Preparer Penalty, by which the preparer may agree to the extension of time for the assessment of the penalty in order to allow the review procedures to take place prior to the actual assessment of the penalty. Finally, even where the penalty has been assessed and the preparer has paid 15% of the penalty and filed a claim for refund pursuant to §6694(c), we have seen quite a few cases where the IRS has proceeded to collect the remainder of the penalty prior to the time for which such collection is permitted by law.

EXAMPLES:

To illustrate the disregard by the Internal Revenue Service of the procedural safeguards, I will tell you about one case in which an H & R Block preparer in the appeal of both negligence penalties and penalties for the willful understatement of tax liability which were proposed against him for his preparation of 1983 and 1984 tax returns for a certain taxpayer. Although I will only relate the circumstances of this one case, it is not an isolated instance where the safeguards were ignored by the Service.

In this case, the Internal Revenue Service sent a 30-day letter to the preparer in August 1986. As indicated, the Service proposed both negligence penalties and penalties for the willful understatement of tax liability for two years' returns. As such, the penalties proposed totaled $1,000 (two $100 negligence penalties and two $400 penalties for the willful understatement of tax liability). The $500 willful understatement penalty is reduced by the amount of the negligence penalty which may be proposed in connection with the same return. The report given to the preparer identified several errors on the return. However, we saw no basis for the contention by the Internal Revenue Service that the preparer had made a willful attempt to understate the taxpayers' liability on the returns. We also felt that adequate grounds existed for the abatement of the negligence penalties.

A member of our Legal Department obtained a Power of Attorney from the preparer and submitted a written protest in response to the 30-day letter within the 30-day period. Despite such timely response, the Internal Revenue Service erroneously assessed the penalties in November and December 1986 (prior to the time that an appellate conference had been held with respect to the penalties). We attempted to get the IRS to correct the assessments which had been made in violation of the Treasury Regulations. Our attempts were unsuccessful. In order to protect the preparer's rights, within 30 days of the assessment of the penalties we submitted to the Internal Revenue Service pursuant to §6694(c) the preparer's payment of 15% of the penalties and claims for refund of such payments on Forms 6118 (Claim of Income Tax Return Preparers). As noted above, the payment of 15% and the filing of the claims for refund prohibited the Internal Revenue Service from collecting the remainder of the penalties until the appeal process and any District Court action regarding the penalties were completed.

Despite the timely filing of the claims for refund, and prior to any action being taken by the Internal Revenue Service with respect to either the written protest filed in September 1986 or the claims filed in December 1986, in April 1987, the Internal Revenue Service informed the preparer that a portion of his joint individual income tax refund for tax year 1986 was being applied to the unpaid portion of of the preparer penalties. Therefore, in April 1987, the Internal Revenue Service collected the remaining balance of the preparer penalties in direct violation of Internal Revenue Code §6694(c). We once again attempted to correct the matter through the Internal Revenue Service Center to no avail.

We attempted to resolve the problem through a Problems Resolution Office of the Internal Revenue Service. In June 1987, we were advised by a Problems Resolution Officer that such office had located the case file for the preparer penalty case and had determined that the file had been returned to the Service's files instead of being forwarded to an appellate officers. The case was eventually forwarded to the appeals officer and in September 1987 an appellate conference was held. The result of the conference was an agreement to the assessment of one $100 negligence penalty for the preparation of the 1984 tax return and the abatement of the two $400 penalties assessed for tax year 1983. The forms by which the preparer agreed to this settlement of the matter were returned to the Internal Revenue Service in October 1987. To this date, the preparer has not received a refund of the three penalties which were has erroneously assessed and collected by the Internal Revenue Service. If the Service had not ignored the written protest filed in September 1986, the claims for refund filed in December 1986, and the applicable Code and Regulation provisions, the preparer would not have been without the $1,000 in penalties collected by the Internal Revenue Service almost a year ago.

CONCLUSION REGARDING PREPARER PENALTIES

Tax return preparers are subject to numerous penalties found in the Internal Revenue Code, including those discussed herein. In addition to the sections of the Code and Regulations which set forth the penalties themselves, there are provisions in the Code and Regulations which provide safeguards against the wrongful imposition and collection of preparer penalties. We feel that more attention needs to be given to these safeguards and their proper recognition and application by the Internal Revenue Service.

Mr. Chairman, this statement for the record is necessarily a lengthy one it goes into detail and gives examples in discussing the current penalty structure in the Internal Revenue Code -- especially as it impacts upon the masses of average individual tax payers -- at least 10 million of whom every year seek our help in complying with our nation's tax laws. Your consideration to our recommendations will be greatly and widely appreciated.

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CC ___ WB ___ (T) ___

H&R BLOCK

Form **2210**

Department of the Treasury
Internal Revenue Service

Underpayment of Estimated Tax by Individuals and Fiduciaries

▶ See separate instructions
▶ Attach to Form 1040 or Form 1041

OMB No. 1545-0140

1987

Attachment Sequence No. 56

Name(s) as shown on tax return

Identifying number

IMPORTANT NOTES

In most cases, IRS can figure the penalty for you and you do not have to complete this form. See the separate instructions for more information.

For 1987, you will not owe a penalty for any underpayment of your taxes, and you do not need to complete this form if you have salary income on Form 1040, line 7, that is equal to or greater than your adjusted gross income on Form 1040, line 31.

If you have salary income that is less than your adjusted gross income, part of the penalty will be waived. You can complete this form through line 32 to figure the net penalty. Or, if you choose, IRS will figure the penalty for you in most cases. See the separate instructions.

Part I Figuring Your Underpayment

1	1987 tax after credits (from Form 1040, line 47 or Form 1041, line 26)			1	2,000
2	Other taxes (see instructions)			2	1000
3	Add lines 1 and 2			3	3000
4	Earned income credit	4	0		
5	Credit for Federal tax on gasoline and special fuels	5	0		
6	Credit for overpaid windfall profit tax attributable to amounts withheld	6	0		
7	Add lines 4, 5, and 6			7	0
8	Subtract line 7 from line 3			8	3000
9	Multiply line 8 by 80% (.80)	9	2400		
10	Withholding taxes from 1987 Form 1040, lines 54 and 58 (or Form 1041, line 31c). (Include any credit from Form 4469.)			10	0
11	Subtract line 10 from line 8. If the result is less than $500, do not complete rest of form			11	3000
12	Enter your 1986 tax (see instructions)			12	2500
13	Enter the smaller of line 9 or line 12			13	2400

			Payment Due Dates			
			(a) Apr. 15, 1987	(b) June 15, 1987	(c) Sept. 15, 1987	(d) Jan. 15, 1988
14	Divide line 13 by four (4) and enter the result in each column. However, if you use the annualized income installment method, complete the worksheet in the instructions and enter the amount from line 26 in each column of line 14	14	600	600	600	600
	Complete lines 15 through 22 for one column before completing the next column.					
15	Estimated tax paid and tax withheld. (For column (a) only, enter the amount from line 15 on line 19)	15	425	150	400	1000
	If line 15 is equal to or more than line 14 for all payment periods, do not complete the rest of this form. However, if you used the annualized income installment method, you must attach this form to your return.					
16	Enter amount, if any, from line 22 of previous column	16		0	0	0
17	Add lines 15 and 16	17		150	400	1000
18	Add amounts on lines 20 and 21 of the previous column and enter the result	18		175	625	825
19	Enter line 17 minus line 18. If zero or less, enter zero. (For column (a) only, enter the amount from line 15)	19	425	0	0	175
20	Remaining underpayment from previous period. If the amount on line 19 is zero, enter line 18 minus line 17	20		25	225	0
21	UNDERPAYMENT. If line 14 is larger than or equal to line 19, enter line 14 minus line 19. Then go to line 15 of next column. Otherwise, go to line 22	21	175	600	600	425
22	OVERPAYMENT. If line 19 is larger than line 14, enter line 19 minus line 14. Then go to line 15 of next column	22				

For Paperwork Reduction Act Notice, see separate instructions.

F ___ HR ___ FS ___
CC ___ WE ___ Ⓣ ___

H&R BLOCK
Form 2210 (1987) Name ____________________ SSN ____/____/____ Page 2

Part II **Figuring the Penalty**

		Payment Due Dates			
		(a) Apr. 15, 1987	(b) June 15, 1987	(c) Sept. 15, 1987	(d) Jan. 15, 1988
23 Underpayment from line 21, page 1.	23	175	600	600	425
Rate Period 1 - 9% (April 15, 1987—September 30, 1987)					
24a Computation starting date for this period	24a	Apr. 15, 1987	June 15, 1987	Sept. 15, 1987	
b Number of days FROM the date on line 24a TO the date line 23 was paid or September 30, 1987, whichever is earlier	24b	$150 61 Days $25 153	$375 92 Days $225 107	Days 15	
c $\frac{\text{Number of days on line 24b}}{365}$ × 9% × underpayment on line 23 (see instructions)	24c	2.26 $ .94	8.51 $ 5.94	$ 2.22	
Rate Period 2 - 10% (October 1, 1987—December 31, 1987)					
25a Computation starting date for this period	25a	Sept. 30, 1987	Sept. 30, 1987	Sept. 30, 1987	
b Number of days FROM the date on line 25a TO the date line 23 was paid or December 31, 1987, whichever is earlier	25b	Days —	$225 Days 92	Days 92	
c $\frac{\text{Number of days on line 25b}}{365}$ × 10% × underpayment on line 23 (see instructions)	25c	$ —	$ 5.67	$ 15.12	
Rate Period 3 - 11% (January 1, 1988—April 15, 1988)					
26a Computation starting date for this period	26a	Dec. 31, 1987	Dec. 31, 1987	Dec. 31, 1987	Jan 15, 1988
b Number of days FROM the date on line 26a TO the date line 23 was paid or April 15, 1988, whichever is earlier	26b	Days —	$225 Days 15	Days 15	Days 91
c $\frac{\text{Number of days on line 26b}}{366}$ × 11% × underpayment on line 23 (see instructions)	26c	$ —	$ 1.01	$ 2.70	$ 11.62

27 Penalty (add all amounts on lines 24c, 25c, and 26c in all columns). Form 1040 filers, if you have an entry on Form 1040, line 7, complete lines 28 through 32. Otherwise, enter the amount from line 27 in the space provided on Form 1040, line 65 and check the box on that line. Form 1041 filers, enter the amount from line 27 in the space provided on Form 1041, line 35 and check the box on that line			27	$ 55 99
28 Enter amount from Form 1040, line 7	28	$		
29 Enter adjusted gross income from Form 1040, line 31	29	$		
30 Divide line 28 by line 29 and enter the result as a decimal amount. Do not enter more than 1.0	30			
31 Multiply line 27 by line 30. This is the amount of your penalty to be waived			31	$
32 Subtract line 31 from line 27. Enter this amount in the space provided on Form 1040, line 65 and check the box on that line			32	$

H&R BLOCK

Computation Worksheet For Lines 24-26, Form 2210

file only

Name ______________________ SSN ______________________

Payment Due Dates		Days Late	April 15	Days Late	June 15	Days Late	Sept. 15	Days Late	Jan. 15
Enter amounts from line 14, Form 2210			600		600		600		600
Date Paid April 15-Sept. 30, 1987	Amount Paid								
4/15/87	425	0	425	0	—	0	—	0	—
	Balance Due		175		600		600		600
6/15/87	150	61	150	0	0	0	0	0	0
	Balance Due		25		600		600		600
9/15/87	400	153	25	92	375	0	0	0	0
	Balance Due								
	Balance Due on Sept. 30	168	0	107	225	15	600		
Date Paid Oct. 1-Dec. 31, 1987	Amount Paid								
	Balance Due								
	Balance Due								
	Balance Due								
	Balance Due								
	Balance Due								
	Balance Due on Dec. 31	92	0	92	225	92	600		
Date Paid Jan. 1-April 15, 1988	Amount Paid								
1/15/88	1000			15	225	15	600	0	175
	Balance Due		0		0		0		425
	Balance Due								
	Balance Due on April 15	106		106		106		91	425

Prepare Form 2210 through line 23 as usual. Then, complete this worksheet, as needed. For each tax payment, in order of the date paid, enter the date paid and the amount paid in the appropriate section of those columns. Taxes withheld are considered paid one-fourth each due date unless a different schedule can be verified. Complete in order each *Due Date* column to a zero balance due before entering any payment in the next *Due Date* column. For each amount paid, enter that amount or the balance due, whichever is less. Any amount paid in excess of the balance due would be entered in the next column and that column would then be completed.

Days Late is the number of days after the due date until the date of payment or Sept. 30 and the number of days, if any, after Sept. 30 until the date of payment or Dec. 31 (for the first three due dates), and the number of days, if any, after Dec. 31 to the date of payment or April 15, 1988 (for all due dates).

Enter the *Days Late* from each line of each column in the column for the same due date on Form 2210, on line 24b for payments on or before Sept. 30, 1987, or on line 25b for payments after Sept. 30 and on or before Dec. 31, or on line 26b for payments after Dec. 31 and on or before April 15. Separate split periods with diagonal lines. (These are the only entries from this worksheet to Form 2210.) Then compute the penalty using the formula on line 24c, 25c, or 26c and the underpayment from this worksheet for each separate period of days late (the amount entered in the *Due Date* column on the days late line, which should be the lesser of the balance due prior to the payment or the payment).

Chairman PICKLE. Thank you, sir.

I found each of your statements interesting and helpful.

Mr. Golato, as a conclusion to your example, I assume the widow came to H&R Block. Did you work out her problems with the Internal Revenue Service?

Mr. GOLATO. Yes, but we were unable to get the penalty abated, because there are strict requirements for the abatement of these penalties and she was unable to meet any of those requirements.

The requirements to abate that penalty were that the information returned is not correct; the IRS was unable to contact the taxpayer because of a change of address; and the person preparing the return did not have the information documents due to illness of the taxpayer or destruction of the taxpayers residence.

Chairman PICKLE. When this case was finally settled, how much extra penalty did she pay.

Mr. GOLATO. It was 37 percent of her deficiency.

Chairman PICKLE. I don't like to hear that. I don't think it is sufficient to say, well, ignorance of the law, because that is a cruel case.

I think individually each of you can pick out individual cases representing a horror story. That is easy. I hope we keep our focus on what you think is the answer.

I made notes on each of your testimonies. Most of you are conducting some kind of a study.

One or two have testified that you hope to finish soon—NSPA, and Mr. Silverman and Mr. Hall. Do you anticipate passing on your recommendations by late summer this year?

Mr. MIRMAN. Yes, sir.

Mr. HALL. Yes, sir.

Chairman PICKLE. We are not on any time schedule. I think it would be a big mistake to have a crash approach to this, because it is not going to be a simple answer. There is a reason for most of those actions.

In any tax system there is a lot of cruelty. But I would request that you do get your reports into us as quickly as you can, so we can coordinate with the other groups that are working on similar problems.

I wanted to ask a general question.

We have pending a taxpayer's bill of rights. Should the government pass a taxpayer's bill of rights?

Mr. SILVERMAN. Mr. Chairman, I think that is long overdue. For some reason we have given the Internal Revenue Service a power that we would not tolerate in any other agency, such as to seize property and sell it without a hearing.

I know of no other agency that is permitted to do that. They can do that currently after a 10-day cooling off period.

I think the taxpayer's bill of rights will increase that period to 30 days.

Legislation might take some time, but something that I think can be corrected easily is the whole penalty abatement process at the service center.

It is drawn out, and it is not workable. Specifically, you write and say my client has reasonable cause for having the penalty abated. You get back a form later, 2 to 4 months later, which is computer generated which says: Your reasons do not meet the criteria for abatement.

It is obvious by the form letter that no one ever read your correspondence. I think the service centers and the IRS could do a lot immediately to address these issues.

The worst penalty provision I ever heard, and thankful was never introduced into law, it was contained in the 1986 act. The original bill contains a provision to allow IRS to maintain all penalties that are assessed in order to fund its budget.

Had this penalty passed and not been removed by the committee, the IRS would have turned into an autonomous agency exempt from the budget process.

With the Federal budget starting on October 1, by Columbus Day they could have funded their fund for the entire year.

I applaud the committee for removing that from the act.

Mr. SKADDEN. The American Institute of CPA's past month endorsed the concept and last week we endorsed specifically the taxpayer's bill of rights as it was voted by the Senate Finance Committee.

Mr. GOLATO. Mr. Chairman, on the taxpayer's bill of rights. In the beginning we took positions in opposition to it because we thought Congress was getting too involved in the details of administering the tax laws. However, the way it appears now we can tolerate it especially for three reasons: to put into law what had been government procedures about not always relying on quotas for promotional purposes. By putting it into law, you give it more muscle than policy, because policy, as shown by some horror examples out in the field, are not the same as they are in the national office of IRS.

Two, more protection in collecting tax by lein and levy. I think that is something that should be done. There are always arguments as to whether adequate notice was given to a taxpayer; you don't know who to believe. There should be more protection for that.

Finally, giving the ombudsman power to put off the collection procedure when there is a controversy.

Chairman PICKLE. Thank you.

Mr. Silverman, here is a business which has not paid FICA taxes, it has been going on for months and months and months. Threats of closures and noncompliance, and finally they reach a point when they said, we will give you so much time or we will have to take action. That notice is given.

They can't comply, won't pay, have not paid. So they move in and seize the property.

You said you would be against that?

Mr. SILVERMAN. Not against it. It has been my experience that the IRS has been rather just in stopping pyramiding of taxes. When somebody gets into a hole, sometimes it is merciful to put them out of business.

But in normal routine cases collection agents are coming in, seizing taxpayers' assets for nonpayment of insignificant sums of money.

Chairman PICKLE. Are you saying IRS seizes property as a routine matter?

Mr. SILVERMAN. Yes. That is exactly what I am saying.

I could cite a number of examples where they have just come and asserted a penalty, the taxpayer protested the penalty, the service never replied to the protest, there was a breakdown in the system. The IRS sent a collection agent out and levied against a bank account.

Chairman PICKLE. Here is a company operating and not paying their taxes. A big sum is owed to the Government. After months and months there is now no way of settling the case, and finally the service threatens to seize the property, sell it, and close them down.

They come down and make assertions that they will follow a certain schedule, and then they file bankruptcy while that matter is pending and start over again. Is that a proper procedure, to let them file bankruptcy and continue operating while that is settled?

Mr. SILVERMAN. I don't think there is a proper procedure so long as there is a provision to stop pyramiding of taxes. I think that is a legitimate concern. I don't think the bankruptcy proceeding would eliminate the prior.

Chairman PICKLE. I take it from your testimony that you are in unison with the other witnesses saying that the code is too complex; there are too many penalties, they are hard to administer and not fair; we ought to have a better approach; and, you will be studying it and will make recommendations as to your views. At least we are recognizing we ought to do a better job of what we have to administer. We will keep that in mind.

Mr. Schulze.

Mr. SCHULZE. Thank you, Mr. Chairman.

I do thank the panel.

Mr. Skadden, your statement that we should have a small number of penalties for a large number of infractions, I agree with totally. I am looking forward to the recommendations from the various groups. That is something, it seems to me, would make this more equitable and imposed upon people in a more fair, at least a perception of equity on the imposition.

Mr. Silverman, on your late payment penalty, I guess my question was the same as the chairman's, did you have any discussions on the Senate side for the taxpayer's bill of rights, and was this one of your recommendations? Were you involved with the formulation of the taxpayer's bill of rights?

Mr. SILVERMAN. Yes, sir, we called this to Mr. Pryor's attention. We were not that involved in the taxpayer's bill of rights, but I think——

Mr. SCHULZE. You would not characterize it as your number one issue or the No. 1 problem?

Mr. SILVERMAN [continuing]. That is right. These are the penalties. That is why we bring it to the top of the list because that is the penalty our clients most frequently encounter, the late payment, underestimating and late filing, probably in that order.

So that is a concern where taxpayer's say, well, I am paying a rate of interest compounded daily and if it changes every 3 or 6 months, depending on the Treasury auction rate, why do I have to pay a penalty. They just don't understand that.

Philosophically to say a debt incurred under the IRS code is a preferred debt, and why the Government makes that distinction I don't know, because there are other debts where the Government does not charge a penalty. The Government has as many loan programs probably as they have IRS penalties.

Mr. SCHULZE. When penalties and interest were 5 percent and previously lower, IRS came to the Ways and Means Committee and said, we have made it profitable for people to not pay their taxes and, in effect, get a loan from the Federal Government at 5 percent, a reasonable analysis. Perhaps, as we do in most things in Government that pendulum has been swinging and it has gone too far. How, philosophically, do we determine where that happy middle ground is?

We don't want to create an incentive for people to avoid the system and we don't want to go too far with the heavy hand of Government. Where do we determine where that point should be?

Mr. SILVERMAN. I am not indicating to make it profitable not to pay taxes. At one point we had a rate of 6 percent for 20 years when the prime rate was close to 20 percent. Taxpayers were not charged much interest then but currently on refunds the Government pays a point less.

Banks charge two or three points over prime, if the IRS charged two or three points over what the Treasury prime rate would be, I think that is a reasonable rate of interest. At best, I must confess it is arbitrary.

Mr. SCHULZE. Don't we in effect try to do that now with the adjustment of rates?

Mr. SILVERMAN. We do with adjustment of rates, but then we come in with a penalty on top of that where the taxpayers are paying 22 or 23 percent.

Mr. SCHULZE. Is it penalties more than anything else?

Mr. SILVERMAN. That is correct. If they are paying 23 percent a year, I think it would be usurious in most States and the debt would be I guess annulled.

Mr. RAU. What Congress did was over react. At the same time it made interest rates more current and compounded interest daily it also adopted new penalties and since has enhanced those penalties.

Mr. SCHULZE. On your illustration of the elderly lady and her tax problems, did she end up paying that penalty or did H&R Block?

Mr. GOLATO. She came to us too late. She paid it without question.

Mr. SCHULZE. Do you use that in your commercials now?

Mr. GOLATO. No, we don't. But I think it important to mention that many times when we talk about sophisticated taxpayer issues, we are talking about a few issues that affect a few people.

What I am trying to do is bring to your attention the fact that there are masses of people out there who, too long in their willingness to comply, just automatically pay the penalties rather than taking the time of finding representation or taking the time to fight the IRS.

Mr. SCHULZE. I believe there should be a method for practitioners to get beyond the computer. I have to say that the present Commissioner has been extremely cooperative in trying to do this.

I think it is important that you have a human being to talk to, especially the practitioners. I am not saying you are right all the time, but I would guess a good deal of the time you are right and you are fighting constant paperwork coming from the computer.

The Commissioner has been very cooperative on this. I suspect we are headed in the right direction. Do you see any improvement on this or are things not any better?

Mr. SILVERMAN. They have one program which is working very well, the problems resolution officer but you have to go through the mill in order to get there. That is the problem.

I don't recall the rules, but I think you have to have two bits of correspondence to the service center before you get to this.

Mr. SCHULZE. Mr. Gibbs is trying on an experimental basis a direct line for practitioners. It is working in the test areas. Perhaps, it will be expanded later on. Perhaps, some of you are not aware of that. I have great hope for it.

Mr. SILVERMAN. That program is working very well. I commend the Commissioner for that.

Mr. SCHULZE. Do you feel you have sufficient access to the service? You have opportunities to have input on your problems.

If you have a series of problems that generate over a 1-year or 2-year period, do you feel that you have adequate access and if not how could that be improved?

Mr. SILVERMAN. I know the Commissioner meets with all professional societies. We meet with him once a year to go over mutual concerns that we have. We have a suggestion box for our members and they write in to our national office.

We have a 2- or 3-hour session with the Commissioner where we exchange our ideas.

They are very receptive. I applaud the Commissioner for taking the time to meet with us.

Mr. GOLATO. I can say the same thing, from designing of the forms and writing of the instructions to problems that may arise we have input anytime we want. I think that in dealing with the IRS, the opportunities are there and they listen.

Mr. SCHULZE. I think that is very important. You are on the front line and your input to the service should be very important. I am glad to hear that.

Mr. GOLATO. I think there has been a recognition that people like us sitting at this table to supplement the IRS in meeting its obligations to administer the tax laws rather than as adversaries.

Mr. SCHULZE. Thank you.

Mr. JACOBS. Mr. Golato, that widow who came to you too late. Did you charge her anything?

Mr. GOLATO. I don't think so. I don't know the answer.

Mr. JACOBS. You are giving me the same answer my staff does: I don't think so, I hope not, I would not think so. Do you know?

Mr. GOLATO. No. There are a lot of questions we answer without any charge and if we are responsible for any mistake we will pay the penalty and interest. If the taxpayer is not satisfied with our service all they have to do is tell us and they get their money back.

Mr. JACOBS. I am sure. I have seen that on the TV. Could you let me know about that, if she was charged?

As long as we are looking into things, I would like to know how your large organization handles such things?

Mr. GOLATO. We certainly will. We will give you the background on that.

[The following was subsequently received:]

She was not charged for our efforts to get the penalties abated.

Mr. JACOBS. You don't have the lady's name, do you?

Mr. GOLATO. No, I don't have that either.

Mr. JACOBS. Mr. Silverman, I suppose I could represent an inability as the fact that the person did not go to the bank on time. I am sure I know what you mean by an inability.

I suppose the person could get to the bank on time if it was fixed dead center in his or her mind to do so.

Mr. SILVERMAN. A day late is the same as a year late, there is not to correct a 1-day oversight procedure.

Mr. JACOBS. But you made a procedure between the people unable to pay taxes and the people unwilling to pay taxes. Who is unable to pay taxes?

I don't understand. Give me a profile of that person.

As I understand it there is no tax on anything but income. Is it a matter of deciding which name to draw out of the hat first, a mere sadist dealer?

Mr. SILVERMAN. Someone who has lost his job and inadvertently found out he didn't have his full tax liability withheld. He could be off by 10 percent. You only have to estimate within 20 percent in 1987 and now it is 10 percent margin of error.

Some people have phantom income. They get a K-1 from an estate where they have to pay tax on funds they never received.

There are a number of examples where people who have fallen on hard times can't pay. I realize there should be a rate of interest.

Mr. JACOBS. I appreciate that. I am not talking about the details. I am trying to get the profile of someone—you say in the case of an estate, one pays tax on income that he never will or could receive.

Could you elucidate on that just a little?

Mr. SILVERMAN. When someone sells property, the taxable gain might be in excess of the actual cash gain, where you have to recapture prior years' depreciation. So someone might buy a piece of property for $10,000, sell it for $11,000 and under the tax law have to report a $5,000 gain on their tax return because they had prior years' depreciation that had to be recaptured.

Mr. JACOBS. You said an estate? I am confused about the situation you cited just now. We are back to the step-up, aren't we, on basis?

Mr. SILVERMAN. Step-up on basis, quite often someone might have to include the income, even though it hadn't been distributed to them.

Mr. JACOBS. Distributed yet, you mean.

Mr. SILVERMAN. That is correct.

Mr. JACOBS. Yet. OK.

It is hard for me to conceive that if I make a dollar and set aside 28 cents—is that what it is these days? I would have an inability to pay unless I used the 28 cents to buy bubble gum first.

I guess the year before last in the 1986 so-called tax reform legislation, the House Ways and Means Committee adopted a provision that if an IRS agent caused expense to a citizen as a consequence of arbitrary and capricious action, not only could that citizen be compensated for his or her attorney's fees or expenses, but instead of laying it on the taxpayers and taking it out of the Treasury it could be taken out of the hide of the one who was arbitrary and capricious.

What do you think about that? The Ways and Means Committee adopted it.

Does anybody want to go first?

Mr. MIRMAN. Are you asking whether we feel that the agents should be held liable for acts that they have committed? Is that what you are asking?

Mr. JACOBS. Arbitrary and capricious acts, I said.

Mr. MIRMAN. Arbitrary and capricious acts.

Mr. JACOBS. If he doesn't like your necktie.

Incidentally, the provision was that there would be no original action, but the Federal judge hearing the case, after the merits were decided, could then hold a separate hearing on whether or not, not that the agent was negligent, not that the agent was mistaken, but if the judge determined that the agent was arbitrary and capricious—not new terms in law—then the agent could be assessed some or all of the expenses to the wronged citizen.

Mr. GOLATO. If it reaches that point, Congressman, I personally have no problem with that. I think it is good to have that type of——

Mr. JACOBS [continuing]. You have no idea in the area of "hell hath no fury" how many problems the Treasury Department had with that.

Mr. GOLATO. I recall.

Mr. JACOBS. It passed on a show of hands 13 to 3, I believe, and I think at least one supporter of that is on the committee in this room now.

The next thing I know the Washington Post called up, got me out in my little fun farm out in Indiana and got me on the phone and this woman, I think Ann Swierson or something like that, said——

Chairman PICKLE. Swartzer.

Mr. JACOBS [continuing]. Swartzer wanted to know if in fact it passed at 3 Sunday morning. I said, yes, that is a fact. But if the implication is that everybody was drunk, including me, and it just came to me then, that isn't true. I testified before this committee, I think, and also Mr. Rangel's committee a couple or 3 years running, and I had reminded the members all through the several weeks of proceedings that at the appropriate time, namely, the miscellaneous session, which of necessity is at the end of the bill—and 3 that Sunday morning was the end of the bill.

Well, didn't it just come up on a voice vote; and I said, yes, it did, but that is not the whole truth because there was a requirement or request for a show of hands and it came out about 13 to 3, as I recall, even hearing what the Mr. Darr person and Mr. Pearl person had to say against it. And wouldn't this have a chilling effect on the performance of the duties of the IRS; I said it would have a chilling effect on arbitrary and capricious acts.

So naturally the next morning it came out in the paper that Jacobs admitted it was 3 in the morning by a voice vote and it would have a chilling effect on performance of duties of the IRS.

I always found Doonesbury to be pretty accurate in that paper anyway.

The next thing I know, it went to the cave of the bones and the conference committee, and that was the last I heard of it. I don't believe it is part of this wonderful reform legislation that was passed in 1986. I didn't want to say that for the record, but I felt forced to do so.

Thank you.

Mr. SILVERMAN. Mr. Jacobs, I am not aware that the IRS has been chilled.

Mr. JACOBS. I figured I was probably audit-proof for about 3 years after that controversy.

But I will tell you, how anybody could object to a well-defined area of the law; namely, arbitrary and capricious acts—how anybody could object to the law against that, it seems to me it is just about as baffling as objecting to murder laws if you didn't aim to murder anybody.

Mr. SILVERMAN. My own observation is I don't think taxpayers are flocking to take on the IRS under that statute.

Mr. JACOBS. It never got through. I don't think they would have anyway. As I say, there was no original action permitted. I wanted to prevent any harassment of the IRS, so it had to be part of the case in chief.

You didn't bring an original action. So I don't know exactly what the objection was, except that I suppose some of the scare stories you have just testified about may have had something to do with it. I don't know.

It seems to me a matter of common sense. If the IRS does something wrong to me, it seems that the fellow who did it ought to be responsible, not the other taxpayers. They didn't do anything. That is how attorney's fees are paid now, even in arbitrary and capricious action cases.

Chairman PICKLE. Before this panel leaves, I will ask a general question here.

Most of you, if not all of you, have complained about the substantial understatement penalty, the IRC section 6661. In terms of corporate noncompliance, what penalty provision is the most effective in terms of enhancing compliance?

Mr. RAU. Mr. Chairman, I think the negligence penalty lends itself to application to those that willfully disregard the regulations or are negligent in complying with the law.

I think the problem with the section 6661 penalty is the law is so ambiguous that people can file a good faith return, have additional tax determined to be due on audit and wind up with a very substantial penalty.

We have other penalties in place now—which can motivate corporate or individual taxpayers—other than the section 6661 penalty.

Mr. GOLATO. I would like to say that the intent for establishing that penalty was to get at tax shelters. As I recall at that time, some people were trying to play the audit lottery, by taking chances because they knew there weren't that many audits being conducted.

But since then, first of all, Congress has seen fit to increase the IRS's budget. There is all likelihood that the number of audits to be made will increase. Computerizing and coming up with better systems of auditing or examining is also being done.

I really think that more audits are important and serve more as psychological deterrence to under-reporting than do penalties. Since the IRS has been concentrating on tax shelters in their audits, very few tax shelters now can escape being caught. So you really don't need so many penalties.

Chairman PICKLE. I think we all wish we had or should have more audits and we must insist on it. That costs money and we are going to announce today an additional hearing with the IRS with respect to their budget and personnel. We think that should be looked at further.

As a general question to all of you, are taxpayers with large penalties assessed, the wealthy or corporate, are they more likely to have their penalties abated than the small taxpayer?

Mr. MIRMAN. Yes, sir.

Chairman PICKLE. Is there any disagreement on that?

They all agree.

Mr. RAU. I don't know that to be true, Mr. Chairman. Obviously if the penalties are material, larger corporations, substantial taxpayers, can afford counsel to represent them. I am sure in a lot of the smaller penalty situations, say, where someone is assessed a $50 penalty, he may just write the check.

So if you are looking at absolute numbers of penalty-payers, that is probably an accurate statement. When you get to dollars, I don't know that that is true.

Mr. MIRMAN. I was talking about the number of people. As long as you have got that number of people going, the smaller taxpayer gets the small amounts, and I have them coming in constantly about 6 months after they have paid them. I say to them, why didn't you bring it in here in the first place, because it's not due. They are not due. But the taxpayer says to me, it costs me more to talk to you than it does to send the money to the IRS.

That is why I said before in my statement that the penalties, the percentage of penalties listed in our statement is low because there are more people that the penalties should be abated and they are not being abated because nobody is complaining about them.

Chairman PICKLE. OK.

Mr. GOLATO. I would like to reemphasize what has just been stated.

There is no question about it, we have a situation where the penalties are taking, in effect, money from complying taxpayers, average taxpayers, masses of them, because they would rather pay that small penalty than go through the process of appealing it or even knowing what the process is.

Chairman PICKLE. You recommend we do away with penalties?

Mr. GOLATO. No. I am answering your question about the numbers—when we were talking about penalties. Too many people don't have representation and don't know the process of getting them abated, even when they are applied inconsistently and unfairly.

Mr. **Mirman**. Mr. Pickle, I would suggest to you that the IRS take a look at the penalties before they are sent out. The problem is they are sent out without even anybody looking at them and finding out that the penalty is wrong. They don't look.

Chairman **Pickle**. I am not here to defend IRS. IRS sent out penalties because Congress put it in the law.

Mr. **Mirman**. I understand that.

Chairman **Pickle**. When Congress passes a law, we find we have to put a penalty on it. If we don't, we find out loopholes occur and we come back and put a penalty. The IRS must respond to the penalty we put in the law.

Are you saying the IRS sends out penalties without looking at them?

Mr. **Mirman**. Yes, sir, I certainly am.

Chairman **Pickle**. Is that in agreement with some others?

Mr. **Silverman**. Yes.

Mr. **Mirman**. I certainly do. Congress doesn't say that. They say they are supposed to put out the penalty. I think before the penalty is sent out, somebody ought to look to see whether that penalty is right.

When a taxpayer gets a 1-cent penalty or a 1-cent deficiency and a $5 penalty and $3 interest on a 941, you have got a problem.

Chairman **Pickle**. All right.

Yes, sir.

Mr. **Silverman**. An example was that the software program wasn't fed into the computer and taxpayers received underestimating penalties even though they submitted proper forms showing they weren't subject to it, and these things just seemed to go out unseen by human eyes.

Chairman **Pickle**. We are going to have another panel now.

Is Mr. Brennan still here with the IRS? Has he flown the coop?

[No response.]

Chairman **Pickle**. Let me ask this before you gentlemen leave.

We have another panel, former IRS commissioners, and we look forward to hearing their testimony. We also have a vote on at this time. If I declare a recess—it is 12:15—say for 30 minutes, would the Commissioners still stay, can you be with us if we have a 30-minute recess or do you want to go right on through?

Mr. Egger, is a recess all right with you?

Mr. **Egger**. It is all right with me, yes.

Chairman **Pickle**. Sheldon Cohen—is he gone?

Mr. **Cohen**. I am here.

Chairman **Pickle**. We will recess for 30 minutes and resume the hearing at that time.

Thank you very much. We appreciate your testimony. Get those recommendations in to us.

[Recess.]

Chairman **Pickle**. The subcommittee will come to order. I am very pleased that five former Commissioners would come to appear before us today. I especially appreciate your cooperation to be on a panel with some of the others. I understand some of you wanted to come later because you had conflicts. It is considerate of you to come and give us testimony. I think you know that I and members of our subcommittee put a great deal of credence on your statements and testimony and recommendations.

You have been through the fire. You have been there. What you say will have specific value to us. So I thank you for it. We have former Commissioners Roscoe Egger, Jerome Kurtz, Donald Alexander, Sheldon Cohen, and Mark Caplin.

I will recognize you in any order you wish. Does anybody have a time schedule particularly?

Well, say Commissioner Egger, our previous Commissioner. We are glad to see you again and we remember you with appreciation and we are glad you would come back again with us today. Will you proceed?

STATEMENT OF ROSCOE L. EGGER, JR., PRICE WATERHOUSE, WASHINGTON, DC (FORMER COMMISSIONER OF INTERNAL REVENUE)

Mr. **Egger**. Thank you, Mr. Chairman.

You may be among some of the few that remember me with appreciation, but that is all right. We understand each other very well. I am here on my personal behalf and though I am presently affiliated with Price Waterhouse, I am not trying to represent the firm here today.

Penalties are unglamorous, complicated, controversial, but critically important to the system of tax administration in the country. During the more than 5 years that I had the privilege of holding that office, the situation had come about where we were going downhill in terms of one-on-one or face-to-face examinations. They were falling off, the whole tax shelter industry had exploded, and as a result, the Congress began to add penalty after penalty in the kind of atmosphere that existed during those years.

The addition of those penalties was done in a less than coordinated fashion. It didn't rely on any particular data that we had in hand. So as a consequence, we wound up in the situation that we are in today. Certainly the starting point for any meaningful examination of the penalty structure in the tax laws is to identify the part which penalties play and which they ought properly to play in tax administration.

Stated very simply, the primary purpose at least of the civil penalty provisions is to enhance voluntary compliance with the system. This is clearly the key to fair and efficient tax collection in a free society such as ours, and the effect of the penalties in that sense should be judged by how they contribute to the process.

So using that as a standard, what I would like to do today is to offer some general considerations and principles which, I think, need to be addressed by your committee in the examination of the structure and then bring to your attention a few specific issues.

So the first principle is proportionality; the punishment ought to fit the crime. If a penalty is totally out of proportion to the severity of the offense, people who are subject to the penalty are going to be wronged, those who are not subject to the penalty are going to be sympathetic, and those that are charged with the enforcement of that penalty will try to find ways not to impose it.

Therefore, under those circumstances, the penalty simply won't function as it is intended to do. It would seem to me appropriate to find ways to limit the severity of the penalties when no harm has been done to the Federal Treasury or the tax administration system.

Let me give an example. If one taxpayer discovers and voluntarily corrects erroneous information return data before that data is used in the matching program. It certainly seems appropriate to me to apply a lesser penalty than if the discovery of the error is made by the Service and the correction is made after the data has lost its usefulness to the system.

Next, comprehensibility and simplicity. Taxpayers need to understand the nature and severity of the penalty sanction. The relatively few penalty provisions that have very broad application ought to be simplified where possible. The Service should be given the additional resources that will be necessary in order to conduct the kind of widespread taxpayer education that will be necessary to bring about an adequate level of understanding.

Penalties should be certain and uniform. Penalties have to be more effective if there is certainty that they will be imposed. And, if penalities are imposed in a hit or miss fashion to only a small fraction of violators, then the effectiveness of the penalty is diminished. When a penalty is enforced, the administration of that penalty must be uniform.

Late versus never. Some penalties do not differentiate between late filing and nonfiling. This aspect of penalty administration provides an incentive for noncompliance when an inadvertent error is discovered. Voluntary compliance is a delicate commodity. If one's noncompliance with one aspect of the system is tolerated, we are on a slippery slope to a more widespread scheme of evasion. A lesser penalty for late filing may be appropriate in most instances.

Increased severity for repeat offenders—if the initial sanction is moderate and measured and it is clear that the next violation will be more severely punished, it is more likely that the taxpayer will comply in the future.

Intentional versus negligent. The law has become so complex that even sophisticated taxpayers may make inadvertent errors in calculating their tax. While fewer no-fault automatic penalties are attractive from an administrative point of view, it is important to balance these considerations with the need for a fair system.

Don't fix a bad penalty by raising the rate. In many instances the Congress has identified that a penalty is not having the desired deterrent effect and has increased the rate of sanction. Often this is appropriate as a result, but sometimes raising the rate on a poorly designed penalty will not increase the effectiveness of the penalty and may possibly even decrease its effectiveness.

Finally, we need a safety-net, one that works. A penalty administration that is designed to answer taxpayers' questions and quickly resolve problems will engender the respect and appreciation that is essential to preserving an increased voluntary compliance.

A word about revenue production. Penalties should not be used to directly raise revenues. The perfect penalty system would enhance voluntary compliance to the extent that no penalties would ever be imposed. Therefore, no direct revenue would be collected.

Using the penalty system to raise revenue brings about disrespect and distrust of the tax system.

Measured against those principles, the current penalty system falls short in many respects. I urge the committee to carefully and deliberately consider proposals for reform.

Mr. Chairman, I don't have with me today a laundry list of proposed penalty changes. Committee work in this area should be slow, careful, and analytical. In the rush to reform and simplify, so many changes can be made that the result is less comprehensible than the original system.

I have some comments on a few special issues, however. Perhaps, no penalty has drawn greater anger and perhaps no penalty has been so effective as the section 6661 substantial understatement penalty. It has been characterized as a no-fault penalty, but a more accurate description would be a penalty on undisclosed aggressive positions that are wrong.

Many commentators have complained that a properly functioning negligence penalty would reach the bad behavior that is intended to be regulated. However, in reality, the Service will not be able to examine more than 1 to 2 percent of the returns for the foreseeable future, and we simply cannot afford to let taxpayers play the audit lottery game for profit.

The negligence penalty has severe problems of definition and administration. These problems greatly limit the penalty's potential as a general deterrent for overly aggressive conduct.

The retroactive effective date of the 6661 penalty is bad tax policy and raises questions of constitutionality. This was the most blatant example of using penalties to raise revenue. The full measure of this unsound policy has not yet been felt.

The negligence penalty's application to the entire amount of deficiency, rather than the amount attributable to negligence is of questionable value.

On the 100-percent penalty that we heard about earlier today, if a person responsible for the collection of trust fund taxes fails to pay those taxes over to the Government, section 6672 imposes a penalty of 100 percent of the tax, while it is clear that this penalty is necessary to reach situations in which individuals fund business operations with trust fund taxes and then abandon the business and the liability, the application of the penalty is sometimes overly harsh.

Oftentimes, a person responsible for the collection and payment includes an unknowing spouse or relative who held a nominal title in a closely held business. In other instances, individuals who held volunteer or honorary positions on boards or as officers of charitable or social institutions found themselves facing a section 6672 penalty.

In response to the political debate on withholding on interest and dividends, the Congress attempted to strengthen the matching system by imposing much sterner penalties for failures related to those types of income. Payers of interest and dividends may be subject to a $50 penalty for failure to file an information return with the Service and a $50 penalty for failure to provide a 1099 to the taxpayer on interest or dividends. Reasonable cause for failure to file will not abate the penalty. Rather, a taxpayer must show that it was duly diligent and still could not comply. If an inadvertent error results in a failure to file for a large bank or large corporation, the result can be penalties that run into the tens of millions of dollars. The fact that the firm may have initiated a reasonably designed and expensive compliance system may not then serve to reduce the size of the penalty.

Over the last few years we have seen a number of new and innovative penalties that are intended to reach tax shelter abuses. At some point in the future it may be appropriate to see whether these penalties can be repealed or modified. For the present, however, we are still in a transition period and in my opinion it is too soon to tell whether the anti-shelter provisions of the 1986 act will have the full intended effect.

I urge this committee to move forward in its efforts to reform the penalty system, but I urge you to move carefully. If changes must be made immediately, they should be structured so as to change as little as necessary like the physician's motto, we should first do no harm. With respect to the special situations that I have identified and similar situations that will be and have been identified by others, the committee should proceed to make the appropriate short-term changes.

However, the long-term projects should be a reexamination of the entire penalty structure with an eye toward provisions consistent with enumerated principles. Further additional changes to the penalty structure should be considered in light of actual experience with the existing structure.

Mr. Chairman, thank you very much.

[The statement of Mr. Egger follows:]

Testimony of Roscoe L. Egger, Jr.

Committee on Ways and Means, Subcommittee on Oversight

Civil Penalty Provisions of the Code

March 31, 1988

Thank you for the invitation to testify today on reform of the civil penalty provisions of the Internal Revenue Code. I am currently associated with the firm of Price Waterhouse, but my testimony today is on my own behalf, and I am not attempting to speak for the firm.

At the outset of my statement, I would like to commend the Chairman and the members of the Subcommittee for their willingness to take on the difficult task of examining the penalty provisions of the Code. Penalties are somewhat unglamorous, extremely complicated, and almost always controversial. Nevertheless, they are a critically important element of the tax administration system.

For the more than five years that I had the privilege of serving as Commissioner of Internal Revenue, the number, scope, complexity and importance of penalties grew at an unprecedented rate. However, even though there are more than 150 penalties in the Code, fewer than 10 have very broad application to taxpayers generally. For its reform efforts, the Committee should focus on these key penalties.

Most of the recent changes in these penalties came in response to perceptions of immediate and pressing crises in the tax system. At the beginning of my tenure as Commissioner, overall voluntary compliance was dropping, the Service was conducting fewer and fewer face-to-face examinations, and the tax shelter problem was beginning to threaten the fundamentals of our tax system. Fortunately, with the support of the Congress, these negative trends have been turned around. But, in that earlier atmosphere, penalty changes were made in piecemeal fashion, with little coordination and with little or no reliable data about the effect of existing penalties or previous changes.

In my role as Commissioner, I was involved in the development of Treasury I, the starting point for the tax reform process. In those early discussions the Service recommended that comprehensive penalty reform be made a part of the overall tax reform process. Recognizing that this would be an extensive and time consuming process, the decision was made to reserve penalty reform for another day, but even then there was a clear recognition of the need to address the area at the earliest opportunity. Hopefully, the time for a careful, deliberate examination of this area has arrived.

Principles of Penalty Design and Enforcement

The starting point for a meaningful examination of penalties is to identify the part that penalties play in our system of tax administration and to articulate the principles that should guide us in the design and administration of penalties.

Simply stated, the prime purpose of the civil penalty provisions is to enhance voluntary compliance with the tax law.

The effectiveness of the U.S. tax system rests totally on the principle of voluntary compliance. While the enforcement functions of IRS; Examination, Collection, and Criminal Investigation, play an extremely important role, the plain facts are that more than 83% of all tax due and more than 95% of all tax ultimately collected is voluntarily reported and paid by compliant taxpayers. The revenue associated with changes in voluntary compliance levels is extremely large and dwarfs the amounts associated with increased direct enforcement efforts. For example, a one percent increase in the level of voluntary compliance will yield approximately $6 billion in revenue.

Voluntary compliance is the key to fair and efficient tax collection in a free society, and the effect of penalties must be judged by their contribution to this process.

Against this standard, I offer the following general considerations and principles that should be addressed in your examination of the penalty structure.

1. Proportionality--The punishment should fit the crime.

In order to further the ethic of voluntary compliance, penalties should be structured so as to engender respect and support from taxpayers and tax administrators. If a penalty is out of proportion to the severity of the offense, those who are subject to the penalty are wronged, those not subject to the penalty are sympathetic to the offender, and those charged with enforcement of the penalty struggle not to impose it. Under these circumstances, a penalty will simply not function as intended.

Also, the principle of proportionality provides the theoretical basis for what has been called the "no harm, no foul rule" of penalty administration. It may be appropriate to limit the severity of penalties when no harm is done to the federal treasury or the tax administration system. For example, if one taxpayer discovers and voluntarily corrects erroneous information return data before that data is used in the matching program, it certainly seems appropriate to apply a lesser penalty than if discovery of the error is made by the Service and the correction is made after the data has lost its usefulness to the Service.

2. Comprehensibility--Simplicity

Penalties are intended to deter undesirable behavior or to encourage compliance with our tax laws. If individuals are expected to respond to the stimulus of a penalty, it is reasonable to believe that they should understand the nature and severity of the sanction.

Assuming that penalties would work better if taxpayers understood the sanctions, the relatively few penalty provisions that have very broad application should be simplified. Further, the Service should be given the additional resources that will be necessary to conduct the kind of widespread taxpayer education that will be necessary to bring about this understanding.

3. Certainty and Uniformity

A penalty is likely to be more effective if there is certainty that it will be imposed. If penalties are imposed in a hit or miss fashion on only a small fraction of violators, the effectiveness of the penalty is diminished.

When a penalty is enforced, the administration of the penalty should be uniform. Without uniform administration, taxpayer perceptions of fairness deteriorate. Perceptions of fairness are crucial to maintaining high levels of voluntary compliance. In this regard, it is important that the Service continue and expand its numerous quality improvement efforts. Increased training and support for IRS personnel is the best method for enhancing uniformity of administration.

4. Late versus never

Some penalties do not differentiate between late filing and non-filing. This aspect of penalties provides an incentive for non-compliance when an inadvertent error is discovered. While I fully understand the "amnesty-like" implications of a lesser penalty if the taxpayer comes to the Service before the Service comes to the taxpayer, I nevertheless believe that this principle is an appropriate one. Voluntary compliance is a delicate commodity. Once non-compliance with one aspect of the system is tolerated, it is a slippery slope to more widespread schemes of evasion. A lesser penalty for late filing may be appropriate in most instances.

5. Increased severity for repeat offenders

The idea of increasing a penalty for repeat offenders has many of the same considerations of fairness that other principles raise. In addition, this consideration raises the issue of "specific" deterrence, that is, how sanctions will affect a specific violator's later behavior. If the initial sanction is moderate and measured, and it is clear that the next violation will be more severely punished, it is more likely that the taxpayer will comply in the future.

6. Intentional versus negligent

The IRS' recent tax gap study identified the fact that a large amount of tax is not reported simply because taxpayers are unaware of the liability. The law has become so complex that even sophisticated taxpayers may make inadvertent errors in calculating their tax. While pure "no-fault" automatic penalties are attractive from an administrative point of view, it is important to balance these considerations with the need for a fair system. A number of existing penalties do make the distinction between a negligent failure and intentional disregard, but this concept should be expanded when possible.

7. Don't fix a bad penalty by raising the rate

In many instances, the Congress has identified that a penalty is not having the desired deterrent effect and has increased the sanction. Often, this is the appropriate result, but sometimes raising the rate on a poorly designed penalty will not increase the effectiveness of the penalty and may possibly even decrease its effectiveness. If a penalty is not working, it is important to look at the design of the penalty as well as its severity.

8. Need for a safety net

A penalty administration system that is designed to answer taxpayers' questions and quickly resolve problems will engender the respect and appreciation that is essential to preserve and increase voluntary compliance. I am sure that many of us have an example of a parking ticket or credit card bill that we just couldn't get corrected. The small dollar amount involved may have soured us on the parking enforcement agency or the credit card company. We cannot afford to alienate Americans from their tax system. The cost is just too great.

For a variety of reasons, people in our society don't write letters to solve problems--they pick up the telephone. It is easier to reach a quick solution of a complicated factual problem through a one-on-one conversation than it is through an exchange of letters. While a written communication may ultimately be necessary to resolve a problem, taxpayers need more than an address at a Service Center to resolve problems.

I am well aware of the technological limitations of the current tax administration system, the cost of new systems, and the lead time necessary to make the fundamental improvements that are necessary. The Service is moving in the right direction on this, but it needs the continued financial and substantive support of the Congress.

9. Revenue production

Penalties should not be used to directly raise revenue. The perfect penalty system would enhance voluntary compliance to the extent that no penalties would be imposed and no direct revenue collected. Using the penalty system to raise revenue brings about disrespect and distrust of the tax system. Taxpayers feel they have been trapped. The negative voluntary compliance effect far outweighs any short term revenue pick-up. If there is a desire to increase revenue in the "compliance" area, a better approach would be to adopt more market oriented interest rates for tax deficiencies.

Measured against these principles, the current penalty system falls short in many respects. I urge the Committee to carefully and deliberately consider proposals for reform.

Special issues

Mr. Chairman, I do not have with me today a laundry list of proposed penalty changes. The committee's work in this area should be slow, careful, and analytical. In the rush to reform and simplify, so many changes can be made that the result is less comprehensible than the original system. I do however have some comments on several special issues.

1. The section 6661 Substantial Understatement penalty.

Perhaps no penalty has drawn greater anger, and perhaps no penalty has been so effective as the section 6661 substantial understatement penalty. It has been characterized as a "no-fault" penalty, but a more accurate description would be a penalty on "undisclosed aggressive positions that are wrong."

Many commentors have complained that a properly functioning negligence penalty would reach the "bad" behavior that is intended to be regulated. However, in reality, the Service will not be able to examine more than 1-2% of returns for the foreseeable future and we cannot afford to let taxpayers play the "audit lottery" for profit. The negligence penalty poses severe problems of definition and administration. These problems greatly limit the penalty's potential as a general deterrent for overly aggressive conduct.

Having said some good things about 6661, let me comment on some of the negative features as well. First, the retroactive effective date of the penalty is bad tax policy and raises questions of constitutionality. This was the most blatant example of using penalties to raise revenue. The full measure of this unsound policy has not yet been felt. Second, the rate of the penalty was increased 150% without an adequate understanding of the effectiveness of the prior 10% rate. Strangely, we now have a 6661 penalty which is intended to moderate positions or elicit a disclosure but the anomaly is that this penalty is usually far greater than the penalty for negligent behavior.

2. The section 6653 negligence penalty.

The negligence penalty's application to the entire amount of a deficiency, rather than the amount attributable to negligence, is of questionable value. I appreciate the administrative problems of a targeted negligence penalty, but the "in terrorem" nature of the current penalty is inconsistent with the principles enumerated earlier. We have already recognized this point in the revision of the civil fraud penalty.

3. The "100 percent" penalty.

If a person responsible for the collection of trust fund taxes fails to pay those taxes over to the government, Section 6672 imposes a penalty of 100% of the tax. While it is clear that this penalty is necessary to reach situations in which individuals fund business operations with trust fund taxes and then abandon the business and liability, the application of the penalty is sometimes overly harsh. Often times a person "responsible" for the collection and payment includes an unknowing spouse or relative who held a nominal title in a closely held business. In other instances, individuals who held volunteer or honorary positions on boards or as officers of charitable or social institutions found themselves facing a 6672 penalty.

Generally, the Service has done an excellent job in reasonable enforcement of this penalty. However, the key to appropriate administration is to get to these businesses before they run up such a large tax liability as to make payment virtually impossible. In order to do this, the Service needs additional Collection personnel who can assist small and medium sized businesses in their efforts to meet their tax obligations. In addition, the Service needs an effective tracking system which will identify non-payment early enough to head-off these runaway situations.

4. Caps and due diligence

In response to the political debate on withholding on interest and dividends, the Congress attempted to strengthen the matching system by imposing much sterner penalties for failures related to these types of income. Payors of interest and dividends may be subject to a $50 penalty for failure to file an information return with the Service and a $50 penalty for failure to provide a 1099 to the taxpayer for interest or dividends. Reasonable cause for failure to file will not abate the penalty. Rather, a taxpayer must now show that it was duly diligent and still could not comply.

If an inadvertent error results in a failure to file for a large bank or corporation, the result can be penalties that run in the millions of dollars. The fact that the firm may have initiated a reasonably designed and expensive compliance system may not serve to reduce the size of the penalty.

If there is an indication that a taxpayer viewed its compliance responsibilities cavalierly or somehow felt that the possibility of a penalty was nothing more than a cost of doing business, I agree that more severe penalties should be imposed. However, many of the current rules are inflexible and can lead to harsh and inequitable results. It may be appropriate to give the Service greater discretion in the application of these penalties.

5. Tax Shelter penalties.

Over the last few years, we have seen a number of new and innovative penalties that are intended to reach tax shelter abuses. At some point in the future it may be appropriate to see whether these penalties can be repealed. For the present, we are still in a transition period and it is too soon to tell whether the anti-shelter provisions of the 1986 Act will have their intended effect.

Conclusion

I urge this Committee to move forward in its efforts to reform the penalty system, but I urge you to move carefully. If changes must be made immediately, they should be structured so as to change as little as necessary. Like the physician's motto, we should first do no harm.

With respect to the special situations that I have identified, and similar situations that will be identified by others, the Committee should proceed to make the appropriate short term changes. However, the long term project should be a reexamination of the entire penalty structure with an eye toward provisions that are consistent with the enumerated principles. Further, additional changes to the penalty structure should be considered in light of actual experience with the existing structure.

Thank you for the opportunity to testify.

Chairman **Pickle**. Thank you, Mr. Egger. These are very helpful analyses and suggestions. I appreciate the manner in which you succinctly analyzed your points and made your recommendations to us.

Now, we will have Commissioner Jerome Kurtz, who represents Paul, Weiss, Rifkind, Wharton & Garrison in Washington.

Commissioner Kurtz.

Mr. **Kurtz**. Here I represent myself, Mr. Chairman.

Chairman **Pickle**. Like Mr. Egger did. He works for Price Waterhouse but is representing himself.

STATEMENT OF JEROME KURTZ, PAUL, WEISS, RIFKIND, WHARTON & GARRISON, WASHINGTON, DC (FORMER COMMISSIONER OF INTERNAL REVENUE)

Mr. **Kurtz**. Thank you for asking me to participate and I am pleased to do so.

I have a statement which I assume will be incorporated in the record and I would like to make a few comments about it, if I may. My statement goes to only one penalty. Let me say first, I agree with everything that Roscoe said.

The penalty structure today is far too complex. As individual ills were perceived, individual penalties were enacted without any view to an overall scheme. We have lesser offenses that will attract big penalties and major problems that attract small penalties. The entire system needs to be rationalized.

In that effort, there is one penalty which is relatively new and which is bound to cause a great deal of controversy. That is the section 6661 penalty which Roscoe Egger alluded to and encouraged you to retain. I do the same and have devoted my statement to it.

One of the questions asked in your invitation to testify was how the penalty structure differs today from what it was when I was Commissioner. Are the changes good or bad? The one major change in the penalty structure from then to now that I see is the section 6661, substantial understatement, penalty. It was enacted in response to a problem that consumed much of my time during my tenure at the IRS and much of Roscoe's and Don's. That is the tax shelter industry—the section 6661 penalty and the tax shelter industry are intimately related.

The penalty basically provides, as you know, that if a taxpayer has a substantial understatement on his return, putting aside for a moment whether the $5,000, 10 percent is the correct threshold, the taxpayer will incur a penalty if there is not substantial authority for the position he took, unless he has disclosed his position on the return, or if the item arises from a tax shelter, unless he reasonably believes that his position is more likely than not correct.

Now, the reason that penalty was enacted and the problem that it addresses is one intimately related to the way our tax system is administered. The IRS audits 1 percent of returns today. It might, in good times, audit 2 or 2½ percent, but our system is largely a self assessing one that depends on taxpayers to interpret the law themselves and to report the proper tax.

Before there was a section 6661, if a taxpayer filed a return, interpreted the law his way which turned out to be wrong and incurred a deficiency, chances are he would have to pay the tax plus interest. Interest tended to be a bargain. So the taxpayer always won, if he had a position to take, short of negligence. He had 98 percent chance he would not be audited at all. So, he "won" in that case. If he was audited, he paid the tax he should have paid in the first place plus interest at a better rate than he would have paid at the bank. What follows is that taxpayers simply need positions that were non-negligent. The tax shelter industry was largely geared to selling reporting positions. That is what it sold. It didn't sell movies or phonograph records or books or gold mines. It sold tax return reporting positions so that the taxpayer could under report his income and if he was detected, pay the tax he should have paid with interest.

Section 6661 says there is a downside risk for a taxpayer who wants to play that game. If he takes a position and if he is not right and the return is examined, he will have a penalty. It was originally 10 percent and it is now 25 percent. Putting aside for a moment whether that is the correct rate.

It is a critical element in administering a self-assessing system. Taxpayers who are in a position to know, that is, sophisticated taxpayers dealing with significant items on their return, know whether they are clearly entitled to a deduction or not. If they want to take an aggressive position, that is perfectly all right. The Service does not have the last word on what the law is. If they want to dispute the IRS, that is fine, but the dispute should be on the merits of the issue by disclosing the position, not on the chance that the return won't be selected for examination. That is essentially what I wanted to call to the committee's attention.

There is one other aspect I might mention that has occurred, I think, as a result of the absence of this kind of a penalty over the years, and that is the increased complexity in the Internal Revenue Code. Much of it is a result of increased specificity in the law in order to require taxpayers to report in accordance with very well-defined rules even though the interpretations of a more general provision would be well understood. Complexity arises from a desire not to leave the taxpayer with a position that he can claim is not negligent.

The only other penalty applicable in this type of situation is for negligence. There is an argument against negligence on almost any issue, so that the legislature has been driven, I believe, to make statutes more and more specific so that a violation will attract a penalty and therefore encourage appropriate compliance in the first instance.

I think section 6661, in the long run, will lessen the need for that degree of specificity in a tax law and improve simplification.

[The statement of Mr. Kurtz follows:]

THE SUBCOMMITTEE ON OVERSIGHT
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
MARCH 28, 1988
TESTIMONY OF JEROME KURTZ

Mr. Chairman and Members of the Subcommittee:

I commend the Subcommittee for undertaking an examination of the penalty provisions of the Internal Revenue Code and I am pleased to respond to the Chairman's invitation to participate in this important work.

There is widespread agreement that the penalty structure today is overly complicated, redundant, uneven in application and inefficient. Many of the provisions are the result of crafting ad hoc responses to particular problems as they were perceived without regard to any overall scheme. The result is that in many cases the severity of the penalty applicable to a particular act or omission seems unrelated to the severity of the offense; sometimes too harsh and sometimes too lenient to achieve the intended result of improved compliance.

You specifically asked that I compare the effectiveness of the current penalty structure with that in existence during my time as Commissioner. While there have been many changes in penalties in the last decade, the change I believe to be of greatest importance is the enactment in 1982 of the penalty for "substantial understatement of liability" contained in section 6661 of the Code. This penalty, more than any other, by changing the basic rules governing the standard of reporting on tax returns, holds the promise of substantially improving compliance, reducing disputes and litigation, improving the perception of fairness of the tax system and, in the long run, in my view, reducing the complexity of the tax law.

The problem of the appropriate standards of reporting on tax returns was one that concerned me all during my tenure as Commissioner. Shortly after assuming office, it became clear to me that the proliferation of tax shelters was threatening a breakdown of our tax system. Respect for the system seemed to be declining rapidly due to the perception that many higher income people were avoiding their fair share of the tax burden and that the IRS was unable to cope with the problem. It was clear that tax shelters were flourishing because audit coverage was low (although much higher than it is today) -- about 2.5% in those years -- and there was little or no downside risk for having claimed deductions disallowed as long as the claimed tax benefit was not due to fraud or negligence. Many tax shelters were designed solely to give taxpayers the ability to claim a tax benefit that would not attract a penalty if disallowed because the claim has some basis. It made no difference that the claimed benefit would almost certainly be disallowed if discovered and challenged. Taxpayers frequently viewed a tax shelter investment as a ticket to the audit lottery. They would win the audit lottery if their returns were not selected for audit and the "ticket" was free because if they were audited and the tax benefit was disallowed, they would only pay the tax they would have paid in the first place, with interest that frequently was at a bargain rate. This was a "no lose" situation for the taxpayer and a crippling one for the tax system. The IRS was forced to devote enormous resources to the tax shelter problem and is only now -- 10 years later -- beginning to see the end as the old cases work their way through the system. IRS has been forced to ignore many of its other responsibilities over the years to address shelter issues and the Tax Court has been overwhelmed with record filings.

Almost 10 years ago (May 20, 1978), I discussed this issue of the reporting standard and the problems that followed from the standard then applicable before a meeting of the Section of Taxation of the American Bar Association,[1/] and what I said then I believe still holds true.

> Now, we audit only a very small percentage of returns, as you know. The percentage is greater for larger businesses and, of course, for the largest corporations it is 100%. Furthermore, as the taxpayer's financial matters become more extensive and complex, the audit itself, while it may be done with frequency, is only a sampling of transactions -- it is not an audit of 100% of the transactions. So, taxpayers can feel with some justification today that where they take a questionable position on their returns -- and I'll try to define that, at least at the extremes -- there is a good chance that they will prevail because the return will not be examined, or if the return is examined the item won't be found.
>
> I'm sure most of you have had the experience that I've had many times in practice in which a client would ask about the taxability of a particular transaction, and you would advise that in your view the matter was taxable, or was not deductible, or was ordinary income rather than a capital gain. The taxpayer would then ask, "Is there any argument at all to take the deduction?" You would say, "Yes, while there are three rulings against it, there is a District Court case in North Dakota that is not exactly on "all fours" but from which one could draw a little solace. The taxpayer would remark, "What will happen to me if I claim it? Will it constitute fraud? Will I be penalized?" And the answer to that question in the best judgment of the adviser, would be "no." The taxpayer would then say, "Thank you, that's all I wanted to know." It's very difficult to run a tax system with a small audit coverage, and with the complexities that we have in our system, where that transaction then gets buried with thousands of others on a return and where the taxpayer clearly knows he is not entitled to the deduction. In fact, he is prepared to concede the issue should it be raised. Let's just start with that problem. If we can agree that that is a problem, then we have our work cut out for us.
>
> One other problem is that this standard of reporting is, I believe, a major cause of complexity in the Code and regulations. Because taxpayers can resolve questionable positions in their favor without disclosure it becomes increasingly important to try to make the law sufficiently clear that it narrows the area of question. Of course, that is extraordinarily difficult to do. We cannot close perceived loopholes or perceived

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1/ Reprinted in 52 Tax Lawyer 13 et seq. (1978).

> improprieties by rulings with any great effect because a taxpayer is free under existing law, by and large, to ignore a ruling on the ground that he believes, or can make an argument, that the ruling does not accurately reflect the law. So the only sure standard is to cover the situation in the statute. I believe that is one reason why the statute over the years has become increasingly specific and complex.

That was the problem and it was a problem that continued to concern me and others at the IRS throughout my tenure and was unsolved at the time I left.

In my introduction to the Commissioner's Annual Report for fiscal year 1980 -- my last report, I said:

> The willingness of taxpayers to "invest" in tax shelter schemes providing claimed tax benefits unlikely to be sustained is, in my view, largely the result of an inadequate penalty structure in our tax laws. The taxpayer is induced to play the "audit lottery" because there is little or no risk or cost in playing and losing. If the taxpayer claims questionable deductions and he is not audited, he has won. (We have reduced but not eliminated the odds against winning by increased audit coverage of these returns.) If he is selected for audit and the claimed deductions are disallowed he may still have won because he has deferred his tax payment at a favorable rate of interest. This deferral period is often quite long, particularly if the taxpayer contests the proposed disallowance in court, even if he concedes before trial.
>
> While the *Internal Revenue Service* provides a penalty for negligence, it is often not sustainable against a taxpayer who claims to have relied on the advice of promoters, their lawyers and accountants, particularly if the transaction involves very complex provisions of law, and frequently even if the professional opinion concludes that the claimed tax benefit is probably not available.
>
> I believe a reexamination of the penalty provisions is in order. If there were a risk commensurate with the claimed rewards then taxpayers and their advisers would make a more realistic assessment of the allowability of the claimed tax benefit before making the "investment." Such penalties could be limited to substantial deficiencies.

Section 6661 responds to these concerns. I believe the Committee will hear complaints about this provision from many sides but I would urge that it not be changed in any material way. It holds great promise of producing a very significant long range improvement in tax administration and preventing a recurrence of a tax shelter binge.

I will be pleased to answer your questions or assist the Committee in any way I can.

Thank you.

Chairman **Pickle**. Thank you, Mr. Kurtz.

Commissioner Alexander.

Mr. **Alexander**. Thank you, Mr. Chairman.

I am glad you didn't mention the name of my firm. I am her anonymously.

Chairman **Pickle**. I will do it. Cadwalader, Wickersham & Taf , Washington, DC.

STATEMENT OF DONALD C. ALEXANDER, CADWALADER, WICKERSHAM & TAFT, WASHINGTON, DC (FORMER COMMISSIONER OF INTERNAL REVENUE)

Mr. **Alexander**. I am still anonymous, very much so, Mr. Chairman. I came here to defend section 6661, but in view of what Roscoe Egger and Jerry Kurtz have said about it, I don't think it needs further defense from me.

Like Jerry and his tenure, I was in office at a time when th penalty structure was simpler, much simpler and it was also grossly inadequate. The audit lottery was being played with great success. If you lost, you won. You would win because the time value of deferring the tax, given the low simple interest charge that the Government was then making when you had to pay up later, would cause you to make money on the deferral.

The negligence penalty was a toothless tiger; the fraud penalty wasn't being asserted very often.

Very seldom was it asserted. When it was, it was generally dropped. So we need a no-fault penalty, although I think that is the wrong label to put on section 6661. Much has been said today by other witnesses about the complexity of the present structure, about the 150 penalties being too many, and maybe the preparers said they should not have penalties applied to them, and other people said they should not have penalties applied to them.

You need to have a strong preparer penalty. You need to get the people who give shabby advice in line. You need to have strong penalties to make the system work for the law abiding taxpayers, and most of them are law abiding. They need assurances that people are going to have to pay their taxes and that the audit lottery will not be a good bargain.

Should you take a look at the overlap between the understatement and the negligence penalty, and consider applying one or the other?

Sure we should.

Do you have a revenue problem if you straighten out the penalty structure by reducing penalties? Of course, unless you fill in some gaps that are mentioned in the joint staff's excellent report. But not all penalties overlap. Joint staff lists the section 5871 penalty. That is a pretty strong penalty—$10,000 or up to 10 years in jail. It is imposed on people who manufacture and sell hand grenades and home made bombs and handguns. I hope that penalty stays. The fact that the manufacturer of the machine gun may also be subject to the fraud penalty and there may be overlap should not call upon this committee to eliminate the overlap.

Finally, Mr. Chairman, back in my day we did not have this type of penalty that serves a very useful function. It is called an additional tax—4975—tax on prohibited transactions in connection with pension funds. Your remedy if you had an offending exempt organization or an offending pension fund, was to pull the exemption of the organization of the fund.

Let's take a pension fund covering thousands of employees. The worst thing you can do is pull that exemption. That hits the innocent employees and barely scrapes the managers who created the problem in the first place. You need to substitute a targeted, complex, system of taxes as described in this pamphlet in order to provide remedial provisions that IRS can use to force compliance, for the managers, the people who created the problem, to correct the problem.

I hope you keep those penalties, the penalties related to pension funds, penalties relating to annuities, private foundations, and exempt organizations. They are necessary ingredients of the law. You could simplify the report by calling them taxes rather than penalties.

Chairman PICKLE. I thank you, sir.

[The statement of Mr. Alexander follows:]

STATEMENT OF DONALD C. ALEXANDER BEFORE THE SUBCOMMITTEE OVERSIGHT, COMMITTEE ON WAYS AND MEANS, U.S. HOUSE OF REPRESENTATIVES, ON CIVIL TAX PENALTIES

MARCH 31, 1988

My name is Donald C. Alexander, and I am a partner in the law firm of Cadwalader, Wickersham & Taft. I am appearing, solely in my personal capacity, at the request of the Subcommittee.

First I want to commend the Subcommittee for its interest in our present complex system of tax penalties and its desire to develop a framework that is fairer, simpler, effective and easier to administer. There is little room for dispute that a searching examination of our present structure is overdue, that overlaps and ambiguities should be reduced, and that the various penalties should be integrated. However, this task should be approached deliberately and cautiously.

With its faults, the present penalty structure is far superior to that which existed when I joined the Internal Revenue Service over a decade ago. A sound and effective framework of penalties is necessary to preserve the integrity of the tax system.[1] The deterrent effect of penalties--a genuine downside risk associated with noncompliance--is vital to assure the many who do comply that those who would avoid their responsibilities will not gain by such attempts.[2] As you pointed out, Mr. Chairman, in announcing this hearing:

> It is important to maintain the trust of honest taxpayers by ensuring that there are proper penalties for those who fail to comply with the tax laws.

Press Release #14, Subcommittee on Oversight, Committee on Ways and Means, March 7, 1988, p. 2.

In the early 1970s, we had a much simpler penalty system. Its problem was its inadequacy, not its complexity. There were penalties for negligence and fraud, both of which focused upon the intent of the taxpayer.[3] The negligence penalty was a toothless tiger, in part due to the showing required to establish its applicability and in part due to its small size (5 percent of the deficiency). In 1981, the negligence penalty was expanded to include 50 percent of the interest on the portion of the underpayment attributable to negligence, and in 1986 the definitional rules of the negligence penalty were materially changed to include "any failure to make a reasonable attempt to comply" with the Internal Revenue Code and any "careless, reckless, or intentional disregard" of rules or regulations. While these changes add somewhat to the deterrent effect of the negligence penalty, they do so at the expense of creating ambiguities and the possibility of uneven administration.

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[1] *See* Joint Committee on Taxation, *Description of Tax Penalties* 3 (Comm. Print 1988). Since this hearing focuses on civil, rather than criminal, penalties, my statement is addressed to such penalties.

[2] My personal view is that the punishment aspect of penalties is of lesser significance than deterrence.

[3] Buttressing these two penalties were penalties for late filing and late payment, and various other penalties for underestimation of tax, failure to file information returns, etc. These penalties (or similar provisions) are necessary but can and should be improved to make them work better.

To impose the civil fraud penalty (formerly 50 percent of the entire underpayment, but now 75 percent of the portion of the underpayment due to fraud plus 50 percent of the interest on such portion), the IRS is required to prove by clear and convincing evidence that the taxpayer committed deliberate or intentional wrongdoing. As one might expect, this penalty has been sparingly used.

The penalties described above fall only on the taxpayer, not on those who market shabby tax merchandise (abusive tax shelters) or those who give bad assistance (return preparers). Yet, clearly, the marketers and the preparers need to maintain high standards if our system is to work properly. The Internal Revenue Code has not repealed Gresham's Law. Penalties were enacted in 1978, are still needed, and should be strengthened, to keep tax return preparers in line. In addition, penalties were enacted in 1982 (and 1984) and are still needed to curb abusive tax shelters.[4] While the 1986 Act (together with certain predecessors) reduced the supply of and market for abusive shelters, they have not disappeared. Even if they had, they would be resurrected by an increase in marginal rates and a likely concomitant restoration of various incentives.

Finally, a substantial downside risk should be present to deter truly aggressive tax planning, even where there is sufficient justification to prevent application of penalties turning upon intent. Accordingly, a "no-fault" penalty was added to cope with material understatements of tax which were not justified by substantial authority or which, with lesser support, were not disclosed to the Internal Revenue Service.[5] This penalty, which counters to some extent the "needle in the haystack" gambit used by aggressive tax avoiders, has aroused much hostility, as will likely be evident from the hearings which this Subcommittee is conducting. While both taxpayers and the IRS alike would benefit from reasonable, uniform, and clear rules interpreting this penalty, and its overlap with other penalties should be addressed, a penalty of this nature is a useful and necessary ingredient to effective administration of our complicated tax laws.

Much has been said about the large number of penalties. Indeed there are many and indeed there is a considerable degree of overlap and confusion. Nevertheless, the fact that there may be about 150 penalties does not mean (1) that all 150 might apply to a particular transaction or course of conduct or (2) that a substantial number of penalties might not be necessary to the sound administration and enforcement of our wide-ranging tax laws.

Some of these penalties (e.g., those relating to private foundations and employee plans) are selective taxes applying to particular types of conduct. It is just as reasonable to consider these to be taxes as penalties. They serve necessary, narrowly-focused functions; but for the utilization of such remedies, the Internal Revenue Service would have the choice of (1) doing nothing or (2) using a sledgehammer -- revocation of exemption -- and thereby hurt the innocent in an effort to punish the guilty.

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[4] Self-regulation or licensing by state or other authorities is not effective for preparers or marketers.

[5] More stringent requirements apply to tax shelters.

Before the enactment of the series of remedial penalties, or taxes, dealing with employee plans infractions, the only remedy open to the Service to stop misuse or abuse was revocation of exemption. This could have a disastrous effect upon thousands of innocent employees covered by plans whose managers were abusing their trust. A system of penalties tailored to the particular offense and providing for a remedial rather than a punitive approach (except in outrageous cases) is far superior, however complex it may appear.

Moreover, the employee plans and exempt organizations penalties, or additional taxes, are complemented by a series of targeted penalties of narrow application. For example, the penalty imposed by section 5871, one of those listed in Joint Staff's excellent pamphlet, imposes a $10,000 fine or imprisonment for not more than 10 years, or both, upon someone violating the provisions of Chapter 53, which deals with the manufacture and sale of machine guns, bombs, grenades and similar destructive devices. The ordinary business corporation or individual does not engage in such practices, and should have no fear of section 5871. Also, the fact that the Code contains a negligence penalty and a fraud penalty, both of which might possibly be applicable to tax-avoiders who manufacture or sell bombs, should not serve as an excuse to lower the number of penalties by repealing section 5871. Similar considerations apply to penalties such as that imposed upon government officials who speculate in sugar (Code section 7240) and the destruction of unregistered stills (Code section 5609).

In your review of the penalty structure, I am sure that you will focus upon the need to produce penalties which bear an appropriate relationship to the magnitude of the penalized offense. A penalty that is too small is likely to be ineffective if used, while an excessive penalty is likely to be ineffective because it will not be used -- or used long. Gaps, as well as duplications, in the penalty structure should be addressed. Penalties should be designed so that they can be understood by taxpayers and the IRS and uniformly administered by the IRS.

As I have stated above, tax penalties are necessary to make our system work. However, I do not mean to suggest that penalties should be viewed as a source of revenue. If the system worked perfectly and there were full compliance, penalties would produce no revenue whatever. Of course, the system does not work perfectly, compliance is not perfect, and it will not be perfect in the future. But assigning revenue numbers to penalties carries the scent of a quota system. If Congress declares that X dollars will be collected by a particular penalty and if the IRS, responsible to and dependent upon Congress for its budget, collects only one-half X dollars, has IRS proved to be an inefficient or ineffective organization? While I am fully sympathetic with the demands of the budget process, I hope that penalties will be viewed in the future as a means to make our system work better by deterring bad tax behavior, thereby increasing the effectiveness and fairness of the system.

In short, our complex and overlapping system of tax penalties needs review and improvement. However, the integrity of our tax system calls for the retention of a comprehensive structure of penalties which impose an effective deterrent upon those who would turn their backs upon their responsibilities as taxpayers.

Chairman Pickle. Now we have Commissioner Sheldon Cohen.

STATEMENT OF SHELDON S. COHEN, MORGAN, LEWIS & BOCKIUS, WASHINGTON, DC (FORMER COMMISSIONER OF INTERNAL REVENUE)

Mr. Cohen. I will repeat what others have said, I speak for myself, Mr. Chairman. I will assume likewise, that my statement is in the record, and I will try to hit a few points that might be of interest to the committee.

The rationale of each new penalty, of course, is justified. You need to look at how they fit together and how they affect the system. You should also see whether some provisions have outlived their usefulness. Of course, we have the reporting requirement, the typical form 1099 requirements. They came in and they came in with a vengeance not because they are needed in and of themselves, but because the Congress enacted the withholding system and then repealed it. In order to recompense the fisc for what came out of that, and you enacted elaborate reporting requirements.

In order to enforce the reporting requirements, you are required to put in very elaborate penalty structures. Like my friends, I agree that section 6661 has a valuable place. I have some fear that there is overuse and automatic use. I will tell you if I were the Commissioner of Internal Revenue I would instruct my staff that every time a penalty can apply, to use it.

These determinations are usually made at the lowest possible level. In order to get uniformity you have to apply them. In order to get discretion, you move up the line. If you enact a penalty you have to assume it is going to be broadly applied, not narrowly applied. Therefore, you have to examine the need carefully each time you put in a new penalty. In order to enforce a mass tax in a decentralized system, as we do, to get any uniformity, you have to instruct your staff to apply it across the board broadly. If these are the facts, apply it. If they meet mechanical tests, apply it.

If you the Congress, want to have exceptions you have to understand you are putting a heavy administrative burden on the IRS to look for justifications after those first qualifications apply. Each one of those cases has to be judged separately. I heard people decrying the fact that they have to write several letters in order to get up the line to find someone who had judgment on some of these calls.

I do want to talk a little bit about something that is important, here. One of the first things that I did when I became Commissioner of Internal Revenue was to request that we in the IRS make a serious study of the way sanctions are applied in the internal revenue system. Here it is. It is 20 years old, commissioned on January 25, 1965, which was the day I took office. This study didn't come out until 1968. It is entitled Report on the Role of Sanctions in Tax Compliance (September 1968).

The reason it didn't come until 1968 was that we examined carefully how criminal and civil sanctions interrelate and whether a change in the mix would be effective. The reason for that was at the time I became Commissioner there were about 1,600 to 1,800 special agents. They are criminal investigators who work two or three cases a year because the cases are very difficult cases to make. If they had been revenue agents they would have raised multiple amounts of direct revenue. That is easy, you can see that on the data.

The hard question is, if you had less criminal law enforcement and more civil sanctions you could raise more revenue. Suppose you had an increased fraud penalty, and an increased negligence penalty, and various other kinds of penalties for other acts and suppose you had publicity about some of those penalties—would you have a more effective system.

We ran the study on whether there would be better enforcement and compliance. We ran the study for 2 years. We questioned people who had gone to jail for tax matters. We questioned judges, social scientists, and our own people. At the conclusion of a couple of years, we were at an absolute dilemma.

Then for the first time ever, we commissioned a study of the general population of the United States and its attitude on tax penalties. That was done by the University of Chicago testing service. A contract was let to the University of Chicago, which was paid for jointly by the Justice Department and IRS. That study came sometime in 1968. That is why the study is dated 1968.

At the conclusion of that study we did not make a change. It is interesting to note that the thing that the American population fears most about a violation of the tax laws is the fact that they might be incarcerated. Those of us at this table have defended or worked with people charged with a tax crime. They would pay any amount of money to buy anonymity and to buy their way into not going to jail. The fact that we send 1,000 or 2,000 people to jail every year for tax crime is an important determent. I think we are leaving that out of this. It has to be an element of any reconsideration.

There were many things that led to attitudes of the general population in 1968. I can't tell you whether those same attitudes exist today but I would implore the committee that before you make dramatic changes in the penalty structure up or down, that you look at the voluntary compliance system. That is what the game is all about.

We have a system that when Mr. Caplan and I were Commissioners, audited close to 5 percent of all returns. Now audits have changed. The code has changed. Business has gotten bigger and more complex. That accounts for a good deal of the changes. The fact that you were at least questioning items on close to 5 percent of the returns had a dramatic ripple effect throughout the community. When you talk about that effect on only 1 percent of the returns, then it has a dramatically different effect on people's attitudes toward the IRS.

Put that together with various controversies that have arisen with regard to this and the taxpayers bill of rights, and a variety of other things, then you find the IRS is held in somewhat less respect today than it was 20 or 25 years ago.

That is not because of us, it is because of the time. I think the most important data in the world is the attitude of those people who fill out tax returns. I don't think you can rely on me or these fellows, and I doubly don't think you can rely on the fellows in the previous panel. We reflect our attitudes on the people we meet. We don't see a cross-section of the population. We see a cross-section of a certain segment of the population. We need to know what everyone thinks.

Our system relies on voluntary compliance. "The important question is: How does everyone react to it." I don't want you, from my point of view, at least, to give more discretion to the Internal Revenue Service. Once before in an Appropriations Committee hearing, I was asked if the Commissioner should not be given more discretion. My response at that time would be similar to the response I would give today.

I said I trusted the Commissioner of the Internal Revenue at that time very well. I thought he was a wise fellow and would make intelligent judgments and therefore, he should be given all the discretion in the world. But then I did not know who would follow him. So maybe it would be better not to give the discretion to me.

You have an agency that touches a lot of people. It does not do good for many people, at least in their view. It does good for the United States in raising 92 or 93 percent of the revenue needed to run the country. But it does not provide a beneficial service as many people would see it. The more discretion IRS has, the more opportunities you are providing complaints about the system and the inequities between judgments.

If you are talking about 25,000 or 30,000 IRS agents on the street questioning people, if they have discretion on applying penalties, the more discretion you give them, the more complaints you will have. Then Mr. Pryor and others on taxpayer rights will have more to complain about.

You cannot prohibit people from making judgments but you have to be careful about what kind of judgments you ask them to make. Penalty judgments are the worst in the world. If an accountant tells a taxpayer an item is questionable and he is not sure it can be sustained, 3 years later when the return is looked at, the taxpayer doesn't remember any of that. Then he feels aggrieved. So you are going to double that by imposing new and harsher penalties.

I am not saying you should not do it, but you should be very careful about this.

Thank you.

[The statement of Mr. Cohen follows:]

STATEMENT OF SHELDON S. COHEN

Mr. Chairman and Members of the Subcommittee:

My name is Sheldon S. Cohen. I am a partner in the law firm of Morgan, Lewis & Bockius. I served as Commissioner of Internal Revenue during the Johnson Administration. I thank you for the opportunity to present my views regarding the numerous penalty provisions currently included in the Internal Revenue Code of 1986. The views I present are my own and are not on behalf of a client or my firm.

I commend the Subcommittee for initiating a comprehensive, systematic review of the tax penalty system. I strongly agree that now is the right time to study the structure and purpose of the penalty provisions, with a view toward developing a "framework that is fairer, simpler, and easier to administer," to quote Chairman Pickle.

It is an appropriate time to begin this effort. The growth in the number, type, and maximum amount of various civil tax penalties during this decade has been extraordinary. Beginning with the Economic Recovery Tax Act of 1981, every piece of major new tax legislation has included significant changes in civil tax penalties. The perception is widely shared that these changes have been enacted piecemeal, lacking any underlying unity or rationale. Indeed, some have been enacted on the hunch they might help, with no detailed study to establish that as a fact. Recent commentary, for example, has characterized the "penalty arena" as "the growth industry in the Internal Revenue Code"1/ and has concluded that "the table has become increasingly tilted toward the Internal Revenue Service."2/ Discussing the tax shelter area specifically, my predecessor as Commissioner, Mortimer M. Caplin, remarked that the new laws "represent a shift" toward "a codification of what may be called 'Crime and Punishment.'"3/ Now is the time to analyze the effect of the new laws on the fundamental elements of our revenue system: voluntary compliance and self-assessment.

It is doubtless true that the principal rationale for each new penalty provision was to increase voluntary compliance by imposing a cost on noncompliance or increasing an existing cost. The two principal trends addressed in this way appear to have been (1) the failure to report income or deductions correctly and (2) widespread participation in tax shelters. In order to increase the accuracy of reporting, Congress has imposed a welter of new information return and other substantiation requirements.4/ Accompanying each new requirement was a set of various penalties for failure to file, filing incorrectly, etc. Then, to attack tax shelters, Congress has enacted various targeted penalty and interest

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1/ Portney & Turner, Penalties: A Weapon to Encourage "Voluntary" Compliance, 11 Rev. Tax'n Ind. 47, 58 (1987).

2/ Garbis & Fisher, The Tilted Table: Penalties and Interest on Federal Tax Deficiencies, 7 Va. Tax Rev. 485, 485 (1988).

3/ Caplin, Tax Shelter Disputes and Litigation with the Internal Revenue Service -- 1987 Style, 6 Va. Tax Rev. 709, 715 (1987).

4/ First you enacted a withholding tax which would have simplified greatly the reporting requirements. Later, at the call of several special interests, you repealed that measure even before it became effective. The increased information reporting rules were enacted in an attempt to make up for that repeal.

provisions, along with other less direct mechanisms (such as the passive activity loss rules).

In addition, Congress has enacted at least three sweeping penalties designed to impose significant costs on taxpayers who fail to comply with the Code. These are the penalty for substantial understatement of income tax (section 6661) and the penalties for valuation overstatements (section 6659) and understatements (section 6660). These penalties are unique in that they are imposed without any determination of "fault" on the part of the taxpayer. In essence, taxpayers are liable for these penalties on the basis of a sheer mechanical, mathematical comparison of the taxes paid with the taxes the Service determines should have been paid. As I will discuss more fully in a moment, I urge you to scrutinize closely the effects of such "no fault" penalties on the voluntary compliance and self-assessment system.

First, however, I would like to address Chairman Pickle's request that I compare the effectiveness of the current penalty structure with that in existence during my term as Commissioner. During my tenure, the civil penalties included the venerable, relatively low negligence penalty, the civil fraud penalty, and various penalties for failure to comply with the comparatively few reporting requirements. In addition, of course, the Code included the various criminal penalties of long standing that have not been changed dramatically during this decade. Prior to the 1970's, the perceived threats of inaccurate reporting and tax shelter abuses were not yet significant enough to force substantial changes in the civil penalty structure.5/ This front was relatively quiet during my watch.

In fact, the question I raised as Commissioner was whether it was still necessary to impose criminal punishment on individuals who failed to comply with the tax laws. This was because there was a feeling by some people that perhaps a civil fraud penalty of 100 or 200%, along with publicity, might be sufficient to deter fraudulent reporting. It should be noted that a Special Agent working criminal cases only handles 2 or 3 cases per year, while a Revenue Agent handles many more. Thus, it was thought increased revenue would result from such a change.

This question led the Internal Revenue Service and the Department of the Treasury to undertake the first comprehensive review of the tax penalty system. The results of that study, which included a public opinion survey, were published as the Service's Report on the Role of Sanctions in Tax Compliance issued in September 1968. If you wish, I will be happy to provide a photocopy of this Report for each Member of the Subcommittee.

The basic conclusion of this Report is that imposing only economic costs on noncompliance (i.e., only civil penalties) is an inadequate deterrent. Unless taxpayers are exposed to possible criminal sanctions, and some individuals are actually incarcerated for failure to comply, the system of voluntary compliance and self-assessment will likely not succeed. Whatever misgivings one might have toward imprisoning an individual largely or solely for the purpose of deterring others from breaking the revenue laws, this

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5/ The Investment Tax Credit and Accelerated Cost Recovery System in the 1980's ballooned the use of such shelters. Repeal of these provisions has as much or more to do with the lower incidence of the shelter abuses than do the new civil penalties.

threat is apparently necessary for the overall success of our tax system.

The Report also includes an evaluation of and several recommendations regarding civil penalties. Some of the latter have now come to pass, in one form or another. For example, the Report recommended increasing the negligence penalty. However, the Report did not address the wisdom of enacting "no fault" civil penalties.

From my dual perspectives as a former Commissioner and as a tax attorney engaged in private practice, the imposition of "no fault" civil penalties causes grave misgivings. It is true, of course, that the Code allows IRS employees to not impose the penalties for substantial underpayment, valuation overstatements, and valuation understatements, if the taxpayer had "reasonable cause" and "acted in good faith." The implementing regulations, however, construe this exception extremely narrowly, to the point of being draconian.

The message to Revenue Agents and other employees of the IRS seems quite clear: except in the most meritorious cases, impose these penalties if the mathematics allows it. The obvious problem is that taxpayers may resent the imposition of such penalties in marginal cases. If such resentment becomes widely shared, the "no fault" penalties may well undermine voluntary compliance rather than strengthen it. Moreover, imposition of such penalties will likely itself become a hotly disputed issue, both in the appeals process within the IRS and in litigation.

I do _not_ recommend that the IRS be given increased discretion regarding the imposition of these and other penalties. The exercise of such discretion is more likely to be perceived as unfair than fair. Instead, I simply urge you to evaluate each penalty, and the civil penalty system as a whole, in light of the likelihood that every penalty _will_ be and ought to be imposed in every case where the Service can argue that the penalty _can_ be applied. In a large organization such as the IRS, that is the only practical way to administer the penalty system.

I am not in a position to assess the results of this approach in the abstract. I do not recommend, for example, simply repealing the "no fault" penalty for substantial understatement of income tax. It may well turn out, however, that the scope of this provision should be narrowed, perhaps by raising the threshold amount.

Once again, I commend you for your willingness to undertake the vexing task of reforming the current unwieldy civil tax penalty system. Please do not hesitate to call on me if I can be of further assistance. I would be glad to respond to any questions you might have at this time.

Respectfully submitted,

Sheldon S. Cohen
Morgan, Lewis & Bockius

March 31, 1988

Chairman **Pickle**. Commissioner Caplin, you have been here since early morning I notice. We didn't intend for you to be last, we are glad to have you here.

STATEMENT OF MORTIMER CAPLIN, CAPLIN & DRYSDALE, WASHINGTON, DC (FORMER COMMISSIONER OF INTERNAL REVENUE)

Mr. **Caplin**. Thank you, Mr. Chairman. It is a privilege to be here. My voice will be very much in tune with the others in this quintet.

Mr. **Rangel**. What law firm is it that you don't represent?

Mr. **Caplin**. It is the law firm of Caplin & Drysdale, and I speak as an individual member, not on behalf of the firm.

I should say we speak mostly with a common voice because we have had common experiences and all of us are now representing corporate and individual taxpayers. Yet, we are all sensitive to the public interest involved in the decisions that your subcommittee will be making.

It has been said again and again that the keystone to our tax system has been voluntary compliance and self-assessment. The reason is that 96 percent of our collections—and we are nearing the $1 trillion a year in this system—comes from self assessment and voluntary compliance. Four percent comes from direct enforcement, penalties and interest. So obviously it is very efficient from a tax administration standpoint to try to improve voluntary compliance. That is where the money is; that is the way to enhance collections at the lowest possible cost.

I think that our penalty policy should be postured and directed in that way, not just toward raising additional revenue dollars through the penalty system. Despite this, in recent years we find that the penalty sticks are beginning to outweigh the carrots in our tax administration. Such a policy stance poses a threat to the fabric of our tax system.

We are getting numerous complaints from clients, very respectable people, both individual and corporate. There is a concern about this shift in congressional and IRS attitudes, and I think it is time that we addressed the issue. Beginning in 1981 and through 1986, we saw a heavy battery of penalties added to the Internal Revenue Code.

As has been pointed out, it is aimed primarily at the tax shelter industry. Yet I submit that the war is essentially over for abusive tax shelters. The 1986 act performed its mission well. Some people said it was overkill, but I think the Congress did an excellent job, albeit a complex one. The new law is reaching the pockets of taxpayers who never knew what an income tax was. With this in mind, the time is now at hand for penalty disarmament—for a coordination, rationalization, and pruning of penalties.

I agree with what has been said here that we need penalties in our tax system just as we need criminal provisions. But they must be selected carefully and aimed at specific targets without overlapping and duplication—always keeping in mind that improving voluntary compliance is the real goal.

Let me comment on a few troublesome issues. First, nondeductibility of tax deficiency interest. That is one of the items you referred to in the announcement of the subcommittee. Second, the uneven administration of the section 6661 penalty for substantial understatement of income tax; and third, the sharp decrease in the number of returns being examined by the IRS each year.

Denying the interest deduction on tax deficiencies is a true no-fault penalty. There are no outs. Interest keeps on running regardless of good faith or reasonable cause. And under the 1986 statute, this interest would not be deductible for an individual. This interest factor is extremely costly in tax disputes. Although we have a normal 3-year statute of limitations, time and time again taxpayers are asked to extend the statute, sometimes under an open extension, form 872–A, which you can cut off at a later date only by giving notice to the IRS and waiting another 6 months.

But interest tends to run on and on. Issues will not be resolved for many, many years. Both understaffing and inadequate budgets also hamper the Service in prompt handling of its caseloads. Numerous returns are often held in suspense for long periods of time due to internal administrative problems and not because of delays caused by the individual taxpayer. That is particularly true when the IRS has an issue it wants to have settled in court and the taxpayer happens to fall in that category of case. He is left sitting there waiting for a report from the IRS on whether he thinks he owes additional tax.

All of this has been exacerbated by the large backlog of cases in tax court. As Chief Judge Sterrett said, it has been reduced from 84,000 to 70,000 cases. In my day at IRS, 20,000 was thought to be a large number. Today, these cases are sitting there with interest accruing through no fault of the taxpayer. If no income tax deduction is allowed for the interest you can see what an extra burden is placed on the taxpayer.

I won't go through all the reasons for correcting that provision added by the 1986 Revenue Act, but I do suggest to this committee that steps be taken to reverse that result which I regard as being more truly revenue driven than anything else embodied in the 1986 statute.

On the question of code section 6661, you have already heard the criticism of its retroactive feature and I will not repeat it. Instead, I would like to turn to the administrative side. I have encountered problems here, and I know others have. There is evidence that revenue agents are being heavy handed in applying this 25 percent penalty. Although the revenue manual calls for a prepenalty review by a district penalty screening committee, a PSC, the process does not seem to be working meaningfully.

Tax practitioners say it is a rubber stamp for the Revenue Agents. Often, the agents automatically set up a 25-percent penalty against each item in the return that they disagree with. For corporate returns in particular, they frequently will do this without carefully addressing the question of whether the taxpayer's position was supported by substantial authority. Substantial authority would provide complete protection in a nontax shelter case to a taxpayer who took a position opposed by the Service. But this evaluation is not being made before the penalty is asserted.

What is happening is that these cases are going to the appeals office and, in many cases, the hearing officers are summarily wiping out the penalties. So why do taxpayers object? The problem is that the taxpayer is severely concerned about this, he is burdened by the problem of combating heavy penalties, and paying extra legal and accounting fees to defend his position. Elimination of the penalty thus has become a bargaining chip; it puts taxpayers in an unfavorable position in negotiating a fair settlement.

If we are going to have the section 6661 penalty, it ought to be carefully administered by the IRS and there ought to be a careful study by the agent before he proposes it in his 30-day letter.

What is "authority"? The statute talks about "substantial authority" in section 6661 and I think the definition ought to be modified. I set out in my written testimony two lists taken from the Treasury regulations. One contains six items that the IRS says is "authority"—code provisions, temporary and final regulations, court cases, et cetera.

The other is a longer list which the IRS says is not authority—for example, treatises, legal opinions, the blue book of the Joint Committee, proposed regulations, and actions on decisions. All of these are said not to rise to the level of authority in considering whether a taxpayer is justified in taking a particular position. There is strong support for the view that all of these items in both lists, should be treated as authority.

The ultimate determination will be made by a court, whether or not there is substantial authority. I certainly would like to have on my side Professor Bittker, in his great treatise on corporate taxation, just as much as a district court out in Montana. Both the views of the court and the observations of Professor Bittker merit consideration in resolving the issue.

Let me turn, finally, to the issue of expanding the number of returns examined annually by the IRS.

In 1978 there were 2.65 percent of individual returns audited and 8.1 percent of corporate returns—a total of 8.4 million returns. In 1986, 10 years later, we have 1.1 percent of individual returns, 2.25 corporate—1.3 million total. That is quite a swing downward. As Sheldon Cohen mentioned in the mid-1960's we were examining over 5 percent of the returns. I think we both recognize that the situation is somewhat different today. The returns are more complex; there is a good deal of information return matching. There are reasons why a 5 percent level of examinations is not feasible today, but I would certainly like to attain at least what we had 10 years ago.

I think the policy of auditing returns on a regular basis where people have the knowledge that there is a 2.5 percent chance or a 5 percent chance of their being audited has a salutary impact on improving compliance. It tends to have a ripple effect and encourages people to file with greater accuracy.

Expanded audit coverage is a far better approach than a regime of penalties for improving voluntary compliance. Many of us in the tax field believe that as the audit coverage percent is lowered so too is the level of compliance. I appreciate the problems of the Service in recruiting competent personnel at current salary levels, and Congress should do something about raising the salaries of revenue agents so as to be more competitive with the private sector. I urge that these efforts be supported and a sufficient number of agents hired to bring audit coverage to the level it was 10 years ago.

Thank you, Mr. Chairman.

[The statement of Mr. Caplin follows:]

Statement by

MORTIMER CAPLIN
Caplin & Drysdale
Washington, D.C.

HEARINGS BEFORE SUBCOMMITTEE ON OVERSIGHT
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

Room 1100, Longworth House Office Building
9:00 a.m., March 31, 1988

My name is Mortimer Caplin, a member of the Washington law firm of Caplin & Drysdale and former U.S. Commissioner of Internal Revenue (1961-64).

The Penalty Problem

The penalty sticks are beginning to outweigh the carrots in the administration of our tax law, and this is posing a serious threat to the fabric of our system. Taxpayers and tax practitioners complain that the law is overly complex and, despite their efforts to comply, they still may face burdensome penalties--even if they follow wrong advice received on a telephone call to the IRS.

Congress enacted a heavy battery of tax penalties in 1981 through 1986 to combat ballooning tax shelter abuses. But the war is essentially over for abusive tax shelters--the 1986 Tax Reform Act performed its mission well. The time is now at hand for penalty disarmament--a coordination, rationalization and pruning of the penalties; and a sustained effort to restore our traditional reliance on voluntary compliance and self-assessment.

A tax system that raises over $800 billion a year--soon to reach the $1 trillion mark--is not that bad. We must be careful not to undermine it by creating a negative public attitude and a heightened adversarial relationship between taxpayers and the IRS.

This Subcommittee is to be commended for its efforts to reverse these adverse trends and to keep pressure on both the Congress and the IRS to resolve the penalty problem.

Let me comment on a few issues which I find particularly troublesome--(1) the nondeductibility of tax deficiency interest, (2) the uneven administration of the substantial understatement of income tax penalty (Code section 6661), and (3) the sharp decrease in the number of returns being examined by the IRS.

Denying Deduction Unfair to Individuals

The interest factor in tax disputes with the IRS is of major significance. Although there is a normal three-year statute of limitations for assessing deficiencies, it is quite common for the IRS to procure extensions of the statute on Forms 872 and 872-A, permitting many additional years to elapse before controversies are finally resolved.

Understaffing and inadequate budgets hamper the IRS in the prompt handling of its caseload. Numerous returns are held in suspense for long periods. Thus, through no fault of their own, taxpayers are often forced to face inordinate slowdowns and damaging interest burdens. All of this is exacerbated by the large inventory of cases pending before the U.S. Tax Court and the resulting delay in resolving controversies. Many date back to the late 1970's, with an enormous interest burden often greater in amount than the asserted tax.

Retroactive denial of these interest deductions in Code section 163(h) is unfair in the extreme. It is tantamount to the imposition of a no-fault penalty on taxpayers who find themselves innocent victims of administrative delays and logjams beyond their control.

In addition, this new rule is certain to have a profoundly adverse impact on our system of IRS administrative appeals, settlements, and tax litigation:

1. Nondeductibility of accruing interest presses taxpayers to strive for as early a resolution of disputes as possible. Simultaneously, however, such expensive time pressures give the IRS agents added leverage in the negotiating process.

2. To avoid conflict and delay, some taxpayers bypass the administrative process entirely--contrary to IRS' desire to have disputes resolved in appeals offices--and move directly into the courts, adding to already crowded judicial dockets.

3. Wealthier taxpayers have extra incentives to select the refund route: pay the proposed deficiency at once, file a claim for refund, and then sue for a refund in the U.S. Claims Court or U.S. District Court. Many taxpayers, however, do not have the resources to finance pursuit of the refund alternative.

4. Disallowing deductions for interest paid on tax deficiencies, while taxing interest received on refunds, fosters the impression that the rules of our tax system are unfairly biased in favor of the government. This appearance of unfairness is especially striking in cases where the underlying tax dispute is a matter of timing--over the proper year to report an item of income or claim a deduction. Such controversies often result in a tax deficiency for one year, and a refund for another, with interest accruing both against and for the taxpayer.

Administration of Section 6661

Under the 1986 Omnibus Budget Reconciliation Act, the penalty for substantial understatement of income taxes was raised from 10% to 25% for penalties assessed after the date of enactment (October 21, 1986). [The 1986 Tax Reform Act established a 20% penalty for returns due after December 31, 1986.] This retroactive feature is widely regarded as inconsistent with penalty philosophy inasmuch as it relates to acts already performed prior to the passage of the statute. The widespread belief that this enactment was totally revenue-driven is hard to refute.

Consideration should be given to correcting this by making the 25% rate applicable only to returns due after December 31, 1986.

On the administrative side, there is evidence that revenue agents are being heavy-handed in applying this penalty. Although the Internal Revenue Manual calls for a pre-penalty review by a district Penalty Screening Committee and a Quality Review Staff, the process does not seem to be followed meaningfully. There is evidence at hand that agents are almost automatically imposing the penalty in many cases before carefully weighing whether "substantial authority" exists for the position taken by the taxpayer--which in non-tax shelter cases would be a complete defense to imposition of the penalty. In many of these cases, the appeals office eliminates the penalties summarily, but in the process an extra burden is placed on the taxpayer and he is put at a severe disadvantage in trying to negotiate a fair settlement.

Change in Definition of "Authority"

Finally, on section 6661, Treasury Regulations § 1.6661-3(b)(2) should be corrected to eliminate the distinction now made between the following two lists, one being recognized as "authority" and the other identified as not constituting "authority":

Authority

1. Applicable provisions of the Code and other statutory provisions
2. Temporary and final regulations construing statutes
3. Court cases
4. Administrative pronouncements, including revenue rulings and revenue procedures
5. Tax treaties and regulations, and Treasury and other official explanations of treaties
6. Congressional intent as reflected in committee reports, joint explanatory statements of managers included in the conference committee reports, and floor statements made prior to enactment by one of a bill's managers

Not Authority

1. Treatises
2. Legal periodicals
3. Legal opinions
4. "General Explanations" prepared by the Joint Committee on Taxation Staff (Blue Book)
5. Proposed regulations
6. General counsel memoranda
7. Actions on decisions
8. Technical memoranda
9. Written IRS determinations (except in the case of the particular taxpayer to whom they were issued)

There is strong support for the view that all of the foregoing items should be treated as "authority" and that practitioners should be free in the first instance to exercise their own judgments on the respective weight to be given to each.

This change in the regulations and a direction to the IRS to monitor more closely the proper application of section 6661 would help ease the tensions that now exist over this provision.

Need to Expand Audit Coverage

There has been a disturbing and dramatic drop in the annual number and percentage of tax returns being examined by the IRS. The correlation of penalties to return examinations is easy to see. The smaller the examination program, the smaller the base for imposing penalties. Further, the comparatively few returns selected for examination are in essence hit twice--once for possible tax deficiencies and once for penalties; similarly, those not selected are twice blessed.

Not that I favor enforcement by penalty. Compliance by penalty hardly breeds cooperation; rather, it occurs in a setting that tends to be abrasive and antagonistic. I would rely more on a broad, quality-based examination program aimed at enhancing compliance and encouraging accurate reporting. The ripple effect of an increased likelihood of audit must be given marked weight.

A strong self-assessment tax system like ours leans heavily on taxpayer confidence that the laws are being administered fairly and that everyone is being called on to pay his proper share of the tax burden. Basic to this is a broad audit program focused on examining a sizeable number of tax returns each year and examining the larger returns on a regular basis, whether it be annually or over a cycle of two, three, five or even ten years. In the early 1960's, the IRS was examining over 5% of the returns being filed. Since then, the examination rate has plummeted. A comparison between 1978 and 1986 tells the tale:

	Individual audit rate (%)	Corporate audit rate (%)	Total returns examined (millions)
1978	2.16	8.01	2.4
1979	2.11	7.44	2.3
1980	2.02	6.48	2.2
1981	1.77	5.05	2.0
1982	1.55	4.73	1.8
1983	1.50	3.64	1.7
1984	1.27	2.66	1.5
1985	1.31	2.39	1.5
1986	1.10	2.25	1.3

True, these overall statistics can be misleading, for particular classes of individual returns and corporate returns are examined at much higher percentages. Also, account must be taken of today's high level of matching of information returns which helps to improve compliance. Then, too, there is the question of the quality of the examination process, for it may do more harm than good to increase statistical numbers while at the same time conducting shabby examinations.

Nevertheless, many of us in the tax field believe that as the audit percentage is lowered, so too is the level of taxpayer compliance. While I recognize the difficulties faced by the IRS in recruiting competent personnel at current salary levels, I urge that these efforts be supported and that a sufficient force of revenue agents and tax auditors be hired and trained to enable them to bring the audit coverage up to at least the 1978 level.

Mortimer Caplin

Washington, D.C.
March 31, 1988

Chairman PICKLE. Thank you, Mr. Caplin. I thank all of you. You gentlemen represent over 25 to 30 years of actual practice of Commissioners in the United States. You are five out of the last eight Commissioners. So what you say has a great deal of bearing on what this committee may or may not do.

You have emphasized a certain point. Let's see if I understand you. One, with respect to the overall codification or change, we should proceed cautiously and carefully. You think it is a good approach, we ought to do it, but you want us to be very careful and not rush into it. I think we all would agree, except you are much more pointed in your caution to us.

Commissioner Egger, you were pushing for this kind of study a year ago when you were Commissioner. I presume you still are and think we are on the right track. Then you proceeded to give me several "howevers", and each of you have. I think we will do that. I don't want the public to think we will be contacting all the groups and making a recommendation in the next few months. That is not possible. We ought to move forward cautiously and carefully.

Most of you indicated you think we ought to have more audits. It is alarmingly low at some 1 percent. The audit rate has been steadily going down from 5 to 1 percent. Is there any realistic hope that we can push it back up to 5 percent?

Mr. CAPLIN. I don't know whether the Service could get to 5 percent in the foreseeable future, but I think it could get to 2.5 percent. I chatted with Commissioner Gibbs with regard to his desire for additional revenue agents. He confirmed that he would very much like to have additional personnel. There was some indication in the newspapers that maybe he was backing off from that position. That is not so. He was emphatic about it.

Commissioner Gibbs was speaking for himself. I suspect that he faced questions of budgeting and limitations imposed by OMB. I think they were the only things that curtailed him in his hiring for the current year.

Mr. COHEN. You know we are hardly back to where we started in 1981. In 1981 we had the same or more personnel than they have today in the audit function.

Mr. EGGER. Just saying we are going to have more personnel by giving them budget authority to hire another 2,500 revenue agents is not all the problem. Right now there is a spread of close to $10,000 a year between the entry level salary of an accounting graduate in the Revenue Service and going into the profession. You can hire 2,500 people that meet the academic requirements of the Government employment rules, but you have to look at the attrition that is happening and, therefore, what is becoming of the well of experience in the Revenue Service.

My understanding is that the rate of attrition is such that 2,500 people coming new into the system is only part of the story. By hiring you have in the range of 4,000 people coming into that system. With 16,000 or 17,000 revenue agents that cuts way down on the experience level. It is more than just hiring more people.

Chairman PICKLE. I think we would like to have more audits, more compliance, more enforcement officials. It is very difficult. We got $55 million additional put in the budget last year for taxpayer service primarily. That was sorely needed. Most of you served at the time when you did not ask for further personnel. You were inhibited from making that recommendation.

Mr. CAPLIN. I was not, sir. President Johnson put a freeze on everything but the Revenue Service.

Mr. KURTZ. The Service was not growing when I was there, in terms of the tasks it was asked to do, but it was getting sufficient funds to keep pace with the growth of the return filings. It is pretty close. It takes an increase to stay even as the law gets more complex and more returns are filed every year.

Chairman PICKLE. I think it has grown in the last 7 to 10 years because of the growth in the Service as a whole. That is understandable. I think you recognize that we are going to have a difficult task of getting extra personnel.

Can we get them?

Mr. CAPLIN. Historically, hiring revenue agents, putting them on the firing line, will bring $10 on the average for every dollar you put into them.

Mr. ALEXANDER. Maybe. Secretary Shultz let me have the largest increase the IRS ever had my first year there. We put a lot of people on, with great difficulty. We never got to 5 percent audit coverage. Despite the views of my distinguished colleague on my right, many of them were single issue audits as I found out very well.

Chairman PICKLE. Would you agree that if we could increase audits, we would decrease the emphasis on penalties?

Mr. KURTZ. You are talking about increasing audits from 1 percent to 2 or 2.5 percent. That is not an effect, it seems to me, which would dictate decreasing penalties. If you are talking about some completely different kind of system in which most returns are looked at, sure. But you have a system which largely depends on peoples' computing their own tax and filing honest returns.

Mr. CAPLIN. We are all talking about section 6661, but that is only being imposed on a very small percentage of the whole universe. One to 2 percent of the returns are being audited. They are the only ones directly exposed to the penalty. They are getting a double whammy. The rest of the public is not bearing the impact.

Chairman PICKLE. Only 1 to 2 percent affected by section 6661.

Mr. KURTZ. I don't agree. The purpose is not to assert penalties and raise revenue, it is so that the people who are not audited and are not assessed penalties are encouraged to file more honestly in the first place.

The only way they are encouraged is if there is a downside risk to doing it wrong.

Mr. CAPLIN. I am not saying don't impose the penalty. I am saying that the penalty—if looked at from its direct revenue raising function—has simply increased the take from $1 to $14 billion.

Mr. KURTZ. It is the $700 billion figure that you have to look at.

Chairman PICKLE. I think you saying the same thing in certain respects. You are saying generally that we should keep section 6661 in some substantive form and not try to do away with it.

Nobody disagrees with that.

Mr. EGGER. No. Definitional problems maybe.

Mr. ALEXANDER. We might review the rate, Mr. Chairman.

Chairman **Pickle**. You former Commissioners are now saying don't give the IRS more discretion.

Mr. **Cohen**. I said that. I think the important points of discretion you give the Revenue Service in terms of you not enunciating the rule, but saying the same in a regulatory program. The more points of conflict you make, so the system is harder to administer.

Mr. **Egger**. I think there are degrees. I would like to see the Congress set a little more specific standards which could then be used by the Revenue Service with proper training and well spelled out ground rules which could then be administered properly.

Chairman **Pickle**. I have some other questions, but I will yield to Mr. Rangel.

Mr. **Rangel**. I want to thank this panel for always being available to assist us with the very complex problems that we face. We are going to have to deal with this problem. There is no easy way to do it. I don't know why I always appreciate you fellows more after you leave office than when you are in.

I want to thank you. We have never had a problem where you have not been available. I think all of you have done well in pointing out the problems that we do have, I don't know how good you were in helping us in bringing some resolution to those problems.

We will have additional hearings. I do know that all of you will be available when we come back and start to do something. I am impressed by what Mr. Cohen said, after all the studies that you had in your administration, you decided to do nothing. I don't think we will have that luxury, but I will feel better knowing all of you are there before we decide what we are going to do.

Thank you.

Chairman **Pickle**. One more question. We have before us the possibility of a taxpayers bill of rights. I assume you are generally familiar with what has come out of the Senate. Do you have any comments about that bill? Is it important? Is it to be recommended? Is it helpful? Do you have any comments?

Mr. **Caplin**. I don't think this bill is desirable. The Commissioner is sensitive to the needs of taxpayers and is already implementing many of the provisions contained in the so-called taxpayers bill of rights. The basic issues are being given high priority without the need for new legislation.

Mr. **Alexander**. Mr. Chairman, you asked three questions: one, is it important, yes; two, is it helpful, no; should it be enacted, no. If it is enacted, where is the Congress going to find the $500 million necessary to pay for it? That is the revenue estimate on the current taxpayers bill of rights, the current revenue cost. It will cost you, according to the joint committee staff, who I respect, admire, and worship in this area, provided of course they are right it will cost $517 million if you were to take the Senate's modified taxpayers bill of rights.

That is a vast improvement over the former bills of rights, but your bill of rights, Mr. Chairman, is a much better bill of rights.

Chairman **Pickle**. I am pleased to hear you say that. I am trying to get an evaluation of your opinions as to what we should do. I think we are all for the bill of rights.

Mr. **Cohen**. The taxpayers ought to have their rights spelled out in the law and they do. The statute is explicit about it. The problem some people get into is that a definition of a tax is that "it is an enforced exaction of the State." The United States without a tax system, is not the United States. Any country without a tax system does not exist.

Therefore, you have to start from the premise that the options of the State take priorities over almost anything else. You start working backwards from there. The difficulty is that in bending over backwards, some Members of both houses have listened to the errors and there are many. If you are dealing with an organization of 100,000 people and each one of them only makes one error a month, you are talking about astronomical number of errors.

People are aggrieved by these errors and there ought to be a system to correct them. If you tell me there is no system to ameliorate the errors, then yes, you have to do something. But if the intent is to ensure that there are no errors, then we have to do something else.

Chairman PICKLE. Mr. Kurtz, do you want to comment?

Mr. KURTZ. I think most of the legislation would be a mistake. The IRS today is really very responsive to the problems that are being raised. Most of the problems that come up in those hearings, the horror stories, and they are horror stories, are administrative problems. They are problems with one person out in the field going astray or they are problems with insufficient instructions out in the field or sometimes problems with the substantive law.

But to start to put minor procedures in the Internal Revenue Code, I think, is a mistake. In the long run it inhibits the service from being responsive to problems as they arise. Unexpected problems are going to arise and the service will be powerless to respond. Your calling the problems to the attention of the service, continuing oversight, I think, is very important.

The history has been that the service does respond, and doesn't need legislation to do so.

Mr. EGGER. I think it is a sad commentary that we have to have legislation to theoretically defend the taxpayers of this country against their Government, where the Government agency that is required by law to go out and collect this $900 plus million every single year, does so under the terms of the statutory authority that created the organization and gives it its marching orders, if you will, and now we are going to pass a law that says we have got to defend our people against that agency.

To me that is just so offensive to the 110,000 people that are in that agency trying to do the job and sure they make mistakes and certainly they will continue. They are human beings. It is just incomprehensible to me, if we need to change the law in any specific way to make it better to administer that tax statute, fine.

Mr. CAPLIN. It is an unfortunate title, too, suggesting that taxpayers need a bill of rights. The Internal Revenue Code long has provided basic safeguards for taxpayers. In turn, the Service is concerned with providing proper hearings and due process for taxpayers. The comparatively few aberratious call for administrative correction and congressional oversight, not legislation.

Chairman PICKLE. Well, I want to thank this panel again. Now I am going to assume that the present IRS officials are consulting with you on changes affecting the penalty area. If they are not, we are going to ask that they certainly do keep in touch with each of you. We would like to have your recommendations. We are not in any hurry. We do think the penalty issue is a severe problem and most of you pointed out to us when you were serving that our penalties are increasing and they are now almost doubled.

I think it is time for us to take a look again at the vast number of penalties and how we have expanded them. I don't know whether it is the Government trying to keep up with the taxpayers trying to avoid a tax, or vice versa. It just seems like one moves and the other moves, and it just keeps ping ponging back and forth.

But we have to have a tax paying system. A voluntary system is the best in the world and we have got to preserve it. Your testimony today will help us as we continue to study this issue.

So, I thank you personally for appearing today. Thank you very much.

We have one more panel. Mr. Fred Goldberg, Mr. Kenneth Gideon, and Mr. Bruce Hopkins. This panel is Mr. Fred Goldberg representing Skadden, Arps, Slate, Meagher & Flom, in Washington, DC, Kenneth Gideon representing Fried, Frank, Harris, Shriver & Jacobson, and Bruce Hopkins representing Baker & Hostetler.

We will start off with you, Mr. Goldberg. We will entreat you to summarize and all your entire statement will be made part of the record.

STATEMENT OF FRED T. GOLDBERG, JR., SKADDEN, ARPS, SLATE, MEAGHER & FLOM, WASHINGTON, DC

Mr. GOLDBERG. Thank you, Mr. Chairman. Congressman Rangel, I wish to clarify that I am here solely in my personal capacity as former assistant to the Commissioner of Internal Revenue and as Chief Counsel of the IRS, and appearing solely on my own behalf.

While serving as assistant to the Commissioner, I had primary responsibility for development of the Agency's tax compliance proposals.

Mr. RANGEL. Talk more directly in the mike.

Mr. GOLDBERG. The tax penalty provisions of TEFRA—there is clearly a consensus that civil tax penalty structure needs a thorough reassessment. There is a clear consensus that the current array of penalties is too complex, results in overlapping sanctions, counter productive incentives, and imposes liabilities that bear no reasonable relationship to the conduct in question.

As is often the case, however, the apparent problems are more readily identified than the appropriate solutions. You and Senate colleagues should be applauded for tackling this difficult and not very glamorous issue. I am confident that whatever specific measures you develop, you will enhance our system of voluntary compliance in large measure because you have decided to go forward in a thoughtful and deliberative manner.

It is refreshing and reassuring to see tax legislation developed with such care outside of the glare of Gramm-Rudman targets and reconciliation deadlines.

My written statement covers the four topics that the committee asked me to address. I would like to limit my comments to several general observations. The penalty system during the past decade has ,been characterized by the enactment of numerous targeted sanctions, sanctions addressed and specific participants in the system in the behavior of taxpayers outside of the general gambit of fraud and negligence.

It is clear that tax return preparers play an important and very positive role in the system. Their role will increase over—during the years to come. Penalties are necessary and an appropriate way to influence their behavior. Penalties focused on tax shelters during the early 1980's were clearly a necessary and appropriate effort to deal with the conduct at that time.

Information reporting is now the hallmark and will be the cornerstone, in my opinion, of individual tax compliance in the years to come. There are no longer tax shelter problems. The primary issue is unreported income, information reporting is the key to making that system work and penalties in turn are an absolute necessity to driving that system successfully because the payers, the people doing the reporting are the ones who make the system work.

We had a discussion, the prior panel talked about audit coverage. With all due respect to my elders, I think it perhaps illustrates a point I want to come to. The environment has changed dramatically. To talk about audit coverage when you are dealing with individuals, in my view, misses most of the point. There are millions and millions of taxpayer contacts today throughout the information returns program. Those contacts do not show up as audit coverage, but as I said, I believe that they are and will be for the future the key to assuring individual compliance with the laws.

I think that that really brings me to the point that I would like to cover today, which is that the tax system functions in a dynamic and changing environment. As the compliance environment changes, it is very important to look at the penalty structure. A penalty structure that was suited to one environment may be wholly ill suited to a environment that is changed.

We have heard a great deal of talk about the 6661 penalty today, in the spirit of public confession, I must admit together with my colleague, Mr. Gideon, I had some significant role in developing that sanction. When it was enacted, it was intended to address the so-called audit lottery, the notion that taxpayers could take non-negligent but aggressive positions, the odds of getting caught were very small and if they were caught, the only downside was to pay the taxes they owed anyway, plus interest that was much below the interest they would have had to pay at their local bank.

That was the problem that the penalty was addressed at. There was a 10-percent sanction that was imposed in the nonshelter context for a substantial understatement, unless the taxpayer had authority for his position, substantial authority for his position, or disclosed the position in the shelter context. There was a somewhat different set of standards. I believe the world of tax compliance has undergone a sea of change since 1986. The Tax Reform Act ushered out, put an end to the era of tax shelters. I believe the Tax Reform Act has ushered in the era of an uncertainty.

One of the very small pieces of that massive legislation increased the penalty for substantial understatements to 25 percent. It is far too early to assess whether section 6661 has worked. I think the one area most fruitful inquiry for the committee is whether the disclosure provisions section of 6661 have worked. Have taxpayers taken advantage of that provision. Under what circumstances have they disclosed? Is that a fruitful area for exploration of how to improve voluntary compliance?

More significant, however, is that I believe that the penalty may well have been OBE'd, overtaken by events. For many taxpayers the dominant reality they must deal with today is the need to comply with highly technical provisions in the absence of any guidance from Treasury. The law may generate Draconian results you may not have intended.

Many benefits, some of us must admit, you didn't contend. Susceptible to many different interpretations or it may simply make no sense. There has been a proliferation of valuation issues well beyond the traditional contexts.

The recordkeeping problems are onerous and burdensome to say the least. Regulations have been drafted with both eyes on the revenue and less than due regard for the statutory language you and your colleagues approved.

Taxpayers are dealing with novel provisions not self-executing. They are the law only if the Treasury promulgates regulations and there are no regulations. I think in this environment it is very fair to ask the question whether substantial authority, the reporting standard we want to hold taxpayers to has lost all of its meaning.

Coupled with this state of what I believe to be substantial uncertainty, is that when the substantial understatement penalty was enacted, it was a novel and very controversial effort to impose a reporting standard. At that time, the alternative was a below market loan from the Government. At the time the penalty was developed, staff gave very serious consideration to increasing the section 6621 interest rate as an alternative to the substantial understatement penalty.

That suggestion was rejected in part on political grounds. In today's world, the section 6621 interest rate has the practical effect of charging taxpayers more on their loan from the Government than those taxpayers would incur if they had borrowed from the bank. I think that leads to a very real question as to the wisdom of the section 6661 penalty rate, certainly at 25 percent.

Liability for the substantial understatement penalty, the no-fault penalty is likely to exceed the liability for the negligence penalty. The bad guy pays less than the guy who commits the no-fault error. I think that if the penalty is retained, and I share the view of the Commissioners, that in some form it is an appropriate sanction, at least two changes ought to be made.

First, Congress ought to make clear that the penalty does not apply in situations where the only authority is the statute. If Treasury cannot provide guidance, it seems unfair to penalize taxpayers who are left to their own devices. More importantly, such a provision would be to express recognition that the greatest challenge the system faces today is uncertainty.

Second, the rate of penalty should be dramatically reduced; 25 percent or 25 percent penalty from a "no-fault violation" has absolutely no justification.

Chairman **Pickle**. No what? You said has no what?

Mr. **Goldberg**. No plausible justification; 25 percent from a no-fault error, I find unjustifiable. I believe a penalty sanction reduced say, for example, to a magnitude of say 5 percent is a sanction suited to the offense and one that would make the penalty much more effective as opposed to less effective.

Again, I think that in looking at the penalties, the most important question is what is the compliance environment we are living in and if you conclude, as I have, that unfortunately that environment today is characterized by uncertainty and ambiguity, complexity and recordkeeping requirements, I think that leads you down a different road than the road we pursued in the past.

Thank you.

[The statement of Mr. Goldberg follows:]

HEARINGS TO REVIEW THE CIVIL PENALTY PROVISIONS CONTAINED IN THE INTERNAL REVENUE CODE

Subcommittee on Oversight,

Committee on Ways and Means

U.S. House of Representatives

Statement of Fred T. Goldberg, Jr.

March 31, 1988

Mr. Chairman and Members of the Committee:

My name is Fred T. Goldberg, Jr., and I am a partner in the law firm of Skadden, Arps, Slate, Meagher & Flom. I am appearing today at the request of the Committee, solely in my personal capacity and as former Assistant to the Commissioner of Internal Revenue (1981-1982) and former Chief Counsel of the Internal Revenue Service (1984-1986). While serving as Assistant to the Commissioner, I had primary responsibility for development of the Agency's tax compliance proposals (including the civil tax penalty provisions) that were ultimately enacted as part of the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA").

There is general agreement among all those involved with the tax system on a regular basis that the civil penalty structure needs a thorough reassessment. There is also some consensus that the current array of penalties is too complex, results in overlapping sanctions and counterproductive incentives, and imposes liabilities that may bear no relation to the conduct in question. As is often the case, however, the apparent problems are more readily identified than the appropriate solutions.

You and your Senate colleagues should be applauded for tackling such difficult -- and not very glamorous -- issues. I am confident that whatever specific measures you develop will enhance our system of voluntary compliance, in large measure because you have decided to go forward in a thoughtful and deliberative manner. It is refreshing and reassuring to see tax legislation developed with such care, outside the glare of Gramm-Rudman targets and reconciliation deadlines.

My remarks are limited to four specific areas that the Committee has asked me to address: (1) some general observations on how to think about the civil tax penalty structure; (2) penalties for failure to comply with information reporting requirements; (3) the "no fault" valuation and substantial understatement penalties; and (4) my sense of how the Internal Revenue Service ("IRS") has fared in litigating penalty cases.

I. Assessing the Penalty Structure

A. The Search for a Theoretical Framework: Wild Goose Meets the Red Herring. Efforts at comprehensive review often begin with a quest for some theoretical framework; consideration of the civil tax penalty structure is no different. Unfortunately, the only guiding wisdom I have ever divined is that civil tax penalties are a useful, but imperfect, means to improve voluntary compliance with our tax laws. Perhaps I am tone deaf, but I have never been able to pick up those elusive and unifying themes that would replace the current system with a limited number of easy-to-understand, easy-to-administer, universally-acclaimed-as-fair-and-effective penalty provisions. Accordingly, my only contribution on this score is a series of somewhat random observations.

B. Questions of Scope: The Meat Axe and the Scalpel. The negligence and civil fraud penalties have been around for quite some time. While a number of questions continue to be raised,* there seems to be general agreement that these sanctions -- focused on taxpayers that engage in "bad guy" conduct -- are appropriate.

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* For some time, it had been suggested that the penalty rates should be increased, but should be computed solely by reference to the understatement attributable to negligence or fraud. The claim was that the penalties were arbitrary because the potential liability bore no necessary relationship to the magnitude of the culpable conduct. The counterarguments were that the uncertain magnitude of the penalties was critical to their deterrent effect (taxpayers could not make a precise cost-benefit analysis), and that the proposed modifications would create serious administrative difficulties. The suggested change was made to the fraud penalty in 1986; I am inclined to think that the negligence penalty should be modified as well. I share whole-heartedly the general view that the Code Section 6653 "interest add on" feature and "presumed negligence" rule for unreported income have no practical deterrent effect, create serious administrative problems, and should be repealed.

The newcomers to the penalty landscape -- and those prompting most concern over the current regime -- are the myriad targeted sanctions that have been added to the Code since the late 1970's. In general, these penalties have focused on: (1) third parties that have an indirect impact on taxpayer compliance, and (2) taxpayer conduct not covered by the negligence and fraud standards. It is clear that substantial work is required to remedy a number of technical and structural defects in these provisions as enacted. Nonetheless, I am convinced that they have facilitated tax administration and have enhanced voluntary compliance.

(1) Third Party Participants. In today's world, there are numerous participants that have an indirect impact on taxpayer compliance. At one end of the spectrum are the return preparers and those responsible for generating information returns, who play an increasingly significant and positive role. At the other end of the spectrum have been those promoting tax protester and certain mass marketed tax shelter schemes. While the types of conduct and appropriate sanctions will vary greatly, third parties at all points on the spectrum can

and should be influenced by potential liability for civil penalties.

(2) Taxpayer Conduct. The types of taxpayer conduct that can and should be influenced by potential penalty liability range beyond the traditional standards of negligence and fraud. To date, efforts to influence taxpayer conduct have included:

(a) penalties targeted at non-filers, those who file protester returns, and those who maintain frivolous positions before the Tax Court;

(b) the substantial understatement (or so-called "audit lottery") penalty, designed to establish a reporting position standard that is higher than the "reasonable basis" necessary to avoid negligence (in the non-shelter context, substantial authority or disclosure; in the shelter context, substantial authority plus a belief that the position is more likely than not to prevail); and

(c) the "no fault" valuation and substantial understatement penalties that address certain types of tax shelter investment activity.

C. The Environment: Bears Hibernate, the Dinosaurs are Extinct. If you conclude that targeted sanctions are appropriate, it becomes critical to monitor the compliance environment on a regular and systematic basis. As that environment changes, the penalty system may need to be modified accordingly. Following are three of the more dramatic changes that have occurred during the past 15 years. The third, changes caused by the Tax Reform Act of 1986, gives urgency to your Committee's efforts.

(1) The Era of Tax Protesters and Mass Marketed Tax Shelters. From the mid-1970's through the mid-1980's, the tax protester movement and certain mass marketed tax shelters posed a very real threat to the tax system as we know it. Penalties targeted at such activities were a necessary and appropriate part of the evolving effort to meet that challenge. With respect to protesters, it now appears that the "hard core" are dropping out entirely while their innocent prey are rejoining the system. With respect to mass marketed tax shelters, the 1986 Act brought them to a sudden and complete halt.* At the same time, however, the IRS and the courts are still struggling with the audit and litigation residue of the

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* They are not extinct -- they are hibernating and will return if tax rates are increased and "incentives" are restored.

tax shelter era. The question becomes whether penalties enacted to meet those challenges should be retained, modified or repealed.

(2) Information Reporting Comes of Age. Next to withholding on wages, information reporting is becoming the cornerstone of individual voluntary compliance -- and its significance can only increase during the years ahead. This development has resulted from the confluence of sophisticated computer technology, rejection of broad-based withholding, recognition that unreported income accounts for the vast bulk of the so-called "tax gap," enactment of far-reaching information reporting requirements, and the demise of mass marketed tax shelters. The civil penalty structure can and should play a significant role in making the information reporting system function properly.

(3) The Brave New World of Tax Reform. The 1986 Act may have spelled the demise of mass marketed tax shelters, but it ushered in what has been referred to as the era of "uncertainty run amok". Significant pieces of tax legislation were enacted in 1976, 1978, 1980, 1981, 1982, 1984, 1986 and 1987. Literally thousands of provisions have been adopted or amended on one or more occasions. While there have been many positive aspects to

these legislative efforts, there is also a troubling downside. The myriad hyper-technical provisions that have been enacted in the name of "base broadening" and "loophole closing" and the sheer volume of changes in the substantive law have created a world of uncertainty and unintended tax consequences. I believe that the problems go far beyond what those responsible for formulating and enacting tax policy and those responsible for tax administration have recognized to date. Indeed, while the income tax system appears to have survived tax protesters and mass marketed tax shelters, it is unclear whether it will survive this most recent challenge. From the standpoint of civil tax penalties, this development raises fundamental questions about the type of conduct that is expected from taxpayers and those responsible for preparing tax returns.

D. *"Interest" on Deficiencies: A Rose By Any Other Name . . . .* Prior to 1982, taxpayers were charged interest on deficiencies at a rate well below their borrowing costs. The practical effect was that taxpayers could obtain below market loans from the government by taking "aggressive" positions that avoided the negligence abyss. This situation was generally remedied in TEFRA (by providing for compounding and the more frequent setting of applicable rates). Since that time, however, and notwithstanding claims to the contrary, the interest rate provisions have become a "penalty-like" surrogate designed to influence taxpayer behavior. For example, this role is explicit in the context of Code Section 6621(c) and the "add on interest" provisions of Code Sections 6653(a)(1)(B) and 6653(b)(1)(B). More generally, while not couched in "penalty" terms, the basic Code Section 6621 interest rate on deficiencies is now well above many taxpayers' borrowing costs.

While it may be appropriate to use the interest rate provisions to influence taxpayer behavior, this role should be acknowledged and treated accordingly in any reassessment of the penalty structure.

E. Anecdotes: As the Saying Goes, "Trust But Verify." Anecdotal evidence regarding penalties can be helpful in highlighting rate anomalies and the need for waiver and abatement provisions. In my experience, however, "real world tales of woe" are more often useful in identifying quality control issues (how well are the provisions in question being administered); they are often an inappropriate guide for legislative action. In this connection, at risk of stating the obvious, it is also worth noting the very large inventory of "Dear Congressman" letters that you never receive. For example:

- "I just wanted to let you know how wise and reasonable the IRS was in waiving/compromising/not asserting a penalty in connection with the audit of my return."
- "Next chance you get, please congratulate the IRS. They caught the *crook and made him* pay his due."
- "Please bear with me, but I must confess to someone. The IRS found me out and made me pay my due."

In my view, communications of this sort would be the rule; the complaints you receive are the rare exception.

F. Pay Attention to the Numbers . . . But Don't Let the Liars Do the Figuring. One of the things I found most striking about my time with the IRS involved the Agency's research and evaluation activity. While it was not used as frequently as it should have been, and the quality of the work product could have been improved in some respects, I came away impressed by the ability and dedication of those involved and their substantial contribution to improving the tax system. Because the IRS has unique access to penalty data, the Agency should be held accountable for monitoring and assessing the administration of penalties. It should also be held accountable for helping to evaluate the penalty structure itself. While the issues are exceedingly complex, I believe that statistical analysis can and should play a major role in the Committee's work and that the IRS must take primary responsibility in this regard.

Having said as much, however, several words of caution are in order. First, as with anecdotal evidence, it is important to distinguish between administrative and structural issues: a given statistical analysis may suggest the need for modified enforcement procedures and improved quality control, a change in the law, or both. Second, penalties are a means to improving voluntary compliance; data regarding frequency of assertion, waiver rates, and penalty dollars collected should be viewed with care because they shed only indirect light on the question of whether the provisions are functioning effectively. Third, much attention has been paid to quotas of late. While I think some of the analysis has been misguided, beware you don't set your own. If your legislative history criticizes the IRS for asserting or waiving some penalty too often (not enough), you are likely to see it asserted or waived less (more) often in the future -- not because the Agency will establish or revise quotas, but because it is committed to carrying out Congressional intent.

G. Justice, Mercy and the Imposition of Penalties. Our system of tax administration places a great premium on consistency and uniformity. A taxpayer's liability should turn on the law, not a subjective judgement by the IRS. Unfortunately, these notions collide head on with the need for "fair play" in the penalties context. The decision whether to assert negligence or fraud necessarily involves a subjective judgement regarding the taxpayer's intent. Penalties that are self-executing, based on "objective" factors, often carry implicit subjective judgments (*e.g.*, whether the taxpayer had substantial authority), and invariably carry subjective standards for waiver (*e.g.*, a judgement that the taxpayer had "reasonable cause").* While there are some who disagree, I believe that vesting such discretion in the tax administrator is both necessary and appropriate; the question is whether any guidance regarding its exercise can (or should) be provided by Congress.

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* In this regard, it should be noted that there is a world of difference between penalties that are asserted at the discretion of the IRS, and those that are self-executing unless waived by the IRS.

One other point worth noting in this context is that there are now more than a dozen different formulations of the penalty waiver standard. My own favorite is that governing the failure by individuals to pay estimated taxes (Code Section 6654(e)(3)): the penalty must be waived,

> "...to the extent the Secretary determines that by reason of casualty, disaster, or other unusual circumstances the imposition of such addition to tax would be against equity and good conscience."*

While some variation in waiver standards may be appropriate, and while many of the formulations may boil down to the same thing, it is worth sorting out what Congress has in mind and limiting the number of formulations accordingly.

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* Needless to say, this standard raises numerous perplexing policy issues that Treasury may wish to address in regulations. For example: Since waivers in part as well as in whole are contemplated, what stacking and ordering rules are appropriate? Must "other unusual circumstances" resemble a "casualty" or "disaster"? Does the massive uncertainty created by the 1986 Tax Act constitute a "casualty, disaster, or other unusual circumstance"? Must the taxpayer establish a causal relationship between the "casualty, etc." and his failure to pay estimated taxes? What are the operative distinctions between "equity" and "good conscience"? Whose "conscience" is at issue? Will "reasonable cause" do in a pinch?

H. Revenue . . . What Revenue? The common wisdom is that penalties should not be used to raise revenue. I agree that "blood money" in the form of penalty assessments should not be part of the Congress' deficit reduction strategy. However, it is clear that penalties can and should be used to raise revenue through improving voluntary compliance. Indeed, my recollection is that the TEFRA revenue estimates were driven by estimates of improved compliance, not increased penalty dollar receipts. Such estimates are no more inexact (and are less pernicious) than many of the revenue estimates that have configured tax legislation since 1982. They can and should be part of the process.

II. Information Reporting Penalties

A. Background. As indicated, information reporting has become the cornerstone of efforts to improve voluntary compliance by individuals. Expanded information reporting was a centerpiece of TEFRA, and each succeeding piece of legislation has further broadened its scope. The rationale is quite straight-forward and compelling: Approximately 90% of the income that is reflected on information returns filed with the IRS is voluntarily reported by taxpayers on their tax returns; voluntary compliance rates with respect to income not covered by information reporting range from 25% to 70%. On the enforcement side, the information returns program is the most cost efficient and least intrusive way of ensuring compliance.

The key to the information returns program is not the easy lead on those who fail to report income reflected on information returns filed with the IRS -- the key is that almost all taxpayers file tax returns that comport with the information returns they have received. As a result, the payors responsible for preparing and filing information returns are the backbone of the system. During my time with the IRS, the Agency was only beginning to focus on the payor side of the equation. At the time, I was troubled equally by the Agency's slow progress and by preliminary indications that payor compliance was at best uneven -- and often far from adequate.

B. Some Implications. The foregoing leads to two conclusions regarding penalties for failure to comply with information reporting requirements. The first is simply that penalties are necessary. While payors are the key to making the system work, their own tax liability is not affected by the information returns they are obligated to prepare, file with the IRS and send to taxpayers. Other than a sense of public duty and customer relations, penalties provide the only incentive for compliance.* Second, efforts to assess the payor penalty system should take into account the current state of payor compliance, and IRS efforts to secure that compliance. The inquiry should focus not only on whether information returns are being filed, but also on whether they are accurate and whether copies are being furnished taxpayers.

C. "Technical" Corrections. A cursory review of the information reporting penalty provisions makes clear that a number of changes are in order.

(1) Structural Defects. The fact that late filers and non-filers are subject to the same per return penalty is troublesome. It seems unlikely that Congress intended to create a system where a payor that is late has an incentive not to file at all (since there is no additional cost and the chances of getting caught are less). The penalty amounts are also in need of review.

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* But see, Clemens v. Revlon, Inc., (5th Cir., No. 87-4259, March 7, 1988), where the Fifth Circuit, reversing the District Court, held that the defendant was liable for consequential damages for filing an erroneous W-2 form with the IRS and negligently failing to correct the error after being notified by the affected employee.

For example, while I believe that the amount of the penalty is properly a function of the number of returns in question, the interest and dividend penalties should be capped (the withholding crusade is ancient history); it may be appropriate to increase the other caps; graduated levies for repeat offenders may also be appropriate; incorrect information may be a more pressing long-term problem than failure to file, and should be penalized accordingly.

(2) Waiver Issues. Standards for IRS waiver of information reporting penalties should also be reviewed. While the problem is exacerbated at present by lack of any maximum liability in the interest and dividend context, I am not convinced that "first time offenders" who come forward voluntarily and cooperate with the IRS in correcting the situation should be subject to any substantial penalty liability. By the same token, some relief to taxpayers who are the object of payor non-compliance may be worth considering.

(3) Housecleaning. At a bare minimum, technical housecleaning is in order. For example, the various information return penalty provisions should be pulled together and made uniform. Overlapping sanctions should be eliminated or rationalized.

III. The "No Fault" Valuation and Substantial Understatement Penalties.

A. Background. The overvaluation penalty was enacted in 1981 as part of the effort to deter investment in tax shelters that utilized non-recourse borrowings and other techniques to grossly inflate the value of assets (and associated tax credits and accelerated depreciation deductions). The penalty turned on the "objective" fact of a substantial overvaluation, without regard to the taxpayer's intent (although waiver was permitted on a showing of "reasonable basis" and "good faith"). While targeted at perceived tax shelter abuses, the penalty by its terms applied for all purposes to individuals and closely held corporations.

The substantial understatement penalty, enacted in 1982 as part of TEFRA, was intended to address the so-called "audit lottery." The sense was that taxpayers were taking non-negligent but aggressive positions on grounds that (a) they were unlikely to be caught; and

(b) if discovered on audit, would be liable only for taxes otherwise owed plus interest at favorable rates. In the tax shelter context, taxpayers were subject to a 10% penalty unless they had substantial authority for their position and reasonably believed they were more likely than not to prevail. In the non-tax shelter context, taxpayers were subject to a 10% penalty unless they had substantial authority for, or disclosed, their position. While never expressed in so many words, the general sense was that a "one-in-twenty" chance had been sufficient to avoid the negligence penalty, and that a "three-in-ten" chance would constitute substantial authority.

B. Subsequent Developments. As I have already indicated, the world of tax compliance changed dramatically in 1986. The Tax Reform Act ushered out the era of tax shelters and ushered in the age of uncertainty. At the same time, among the multitude of miscellaneous amendments adopted in 1986, one increased the substantial understatement penalty from 10% to 25% and another adopted an undervaluation counterpart to the overvaluation penalty.

C. Evaluating the Penalties. It is far too early to evaluate the penalties on their own terms.* Preliminary indications are that the overvaluation penalty and the tax shelter side of the substantial understatement penalty, at a minimum, have helped deter shelter investments and have encouraged settlement of numerous pending cases.

More significant, however, is that the penalties may well have been OBE'd -- that is, overtaken by events. In particular, it seems to me that the following developments call into serious question whether these sanctions should be retained in any form.

(1) For many taxpayers, the dominant reality each filing season is that they must deal with the following:

(a) The need to comply with highly technical statutory provisions in the absence of any interpretative guidance from the Treasury Department. As drafted, the law may: generate draconian results that

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* One question that should be explored by the Committee relates to the disclosure provisions of the substantial understatement penalty. Presumably, the IRS has had sufficient experience with returns filed since 1982 to form some views on whether taxpayers are utilizing this route and, if so, in what contexts.

Congress could not have intended; confer benefits that (one must admit) Congress may not have anticipated; be susceptible to several reasonable and plausible interpretations (with differing effects on tax liability); or be simply unintelligible.

(b) Proliferation of "valuation issues" far beyond the traditional realm of Section 482.

(c) Impossibly burdensome record-keeping requirements that, at best, can be complied with in spirit only.

(d) Regulations that (from the taxpayer's perspective) seem to have been drafted with both eyes on revenue, and less than due regard for statutory language and Congressional intent.

(e) Novel provisions, crafted out of whole cloth and with no statutory or "common law" precedents, that call on Treasury to adopt and implement substantive rules -- where no regulations have yet been issued.

In this environment, the notion of "substantial authority" may well have lost its meaning.

(2) When enacted, the substantial understatement penalty was intended to create a downside risk for taxpayers playing the so-called audit lottery. Against the backdrop of Code Section 6621, as it then existed, the object was to make certain that aggressive taxpayers had more at stake than the obligation to repay a below market loan from the government. Indeed, the notion of a differential interest rate on deficiencies was given serious consideration at the staff level as an alternative to the substantial understatement penalty -- but was rejected (in part) as not feasible for political reasons. Since Code Section 6621 in its current form now imposes an above market interest rate on many taxpayers, it may well have supplanted the need for the substantial understatement penalty.

(3) During the past several years, the tax law has introduced a whole host of valuation issues that did not exist in 1981 when the overvaluation penalty was enacted, or that have become much more significant since that time. I seriously question whether the overvaluation penalty was intended to, or should, apply in many of these situations. In this regard, it is also worth noting that (at least in my experience) the IRS continues

to miss the valuation mark in many cases by a wide margin -- often, by more than the taxpayer.

D. Potential Modifications. If the "no fault" penalties are retained, a number of modifications are in order. Following are among the changes that seem warranted.

(1) The original substantial understatement penalty was a controversial effort to codify an appropriate reporting standard. Its novel concepts ("substantial authority," "disclosure," and the like) have not been developed and it is unclear whether they are workable in practice. The question of whether 10% was too low -- or too high -- as a "no fault" levy was never explored or analyzed. Under such circumstances, there was no justification for increasing the penalty rate to 25% in 1986. To illustrate the absurdity of this change, the cost of a "no fault" error now exceeds the price tag on negligence in many cases. Particularly in light of the new Code Section 6621 provisions, the penalty rates should be reduced considerably.*

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* In my view, reducing the rate (e.g., to 5%) would be revenue positive -- taking into account the increased likelihood of assertion and the impact on voluntary compliance of a "fair and credible" penalty.

(2) Congress should also make clear that the substantial understatement penalty does not apply in situations where the only authority is the statute itself. If Treasury has not provided guidance, it seems unfair to penalize taxpayers left to their own devices.* More importantly, it is an express recognition that the greatest challenge facing our tax system is uncertainty -- and is a small step towards making the government accountable for remedying the situation.

(3) Code Section 6659 should be amended to provide that if the IRS misses the valuation mark by more than 25%, the penalty should not apply. This seems only fair -- if the proper value was so difficult to ascertain, the taxpayer should not be penalized.

IV. Penalties, the IRS, and the Courts.

With respect to the "traditional" penalties (negligence and fraud), the most noteworthy aspects are:

(a) the infrequency with which they have been litigated (one exception is the numerous tax protester cases where negligence -- but not fraud -- has been successfully asserted; *see*, *e.g.*, *Reiff v. Commissioner*, 77 T.C 1169 (1981) (taxpayer liable for negligence penalty for failure to disclose sufficient data to compute tax liability and for disregard of statute and regulations in failing to treat wages as income));

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* Needless to say, if the statute is sufficiently clear on its face, the taxpayer may be liable for negligence or fraud.

(b) the government's uneven success, or perhaps the courts' uneven standards, in applying the fraud penalty (*compare*, *Solis v. Commissioner*, 47 T.C.M. (CCH) 726 (1983) (taxpayer with eight-year audit history including concessions to fraud penalties and substantial understatements of tax liability and history of failure to report income or keep adequate records not sufficient to establish fraud even though tax payer engaged in substantial tax return preparation business) *with Swafford v. Commissioner*, 32 T.C.M. (CCH) 528 (1973) (taxpayer's failure to keep records or file returns while conducting business transactions involving large amounts of cash sufficient to establish fraud));

(c) the fact that the fraud issue is frequently litigated in the statute of limitations context (the statute has been "blown" unless the taxpayer has committed fraud, *see*, *e.g.*, *Stone v. Commissioner*, 52 T.C.M. (CCH) 264 (1986));

(d) the enormous cost and expense of developing and pursuing (and defending) such cases; and

(e) the fact that interpretative issues are still being addressed by the Supreme Court long after enactment of the negligence and fraud statutes (see, e.g., Asphalt Products Co. v. Commmissioner, 55 U.S.L.W. 3806 (1987), rev'g 796 F.2d 843 (6th Cir. 1986) (interpreting scope of negligence penalty under Code Section 6653(a)).

Of all these points, the one meriting attention by your Committee relates to the statute of limitations. In my experience, the government's problems in this area generally arise from the difficulty of discovering unreported income and/or the pendency of a criminal investigation -- not from IRS mistakes. It may be worth looking for some solutions if IRS data suggest systematic difficulties in this area.

With respect to the "targeted" penalties enacted since the late 1970's, several preliminary conclusions can be drawn:

(a) the government has been quite successful in asserting those aimed at tax protesters (the frivolous return and delay provisions). In my view, the government's uniform assertion of these penalties, and the courts' overall willingness to impose the requested sanctions, have played a major role in curbing tax protester activity.

(b) To date, the decided cases involving the other targeted penalty provisions have focused on issues of substantive interpretation (see, e.g., Todd v. Commissioner, 89 T.C. 912 (1987) (no liability for valuation overstatement under Code Section 6659 when property in question never "placed in service"); compare Waltman v. United States, 618 F. Supp. 718 (M.D. Fla 1985) (interpreting penalty for promoting abusive tax shelters under Code Section 6700 to apply separately to each sale of abusive tax shelter interest and not to tax shelter activity as whole) with Spriggs v. United States, 660 F. Supp. 789 (E.D. Va 1987) (interpreting penalty under Code Section 6700 not to apply separately to each sale of abusive tax shelter interest, disagreeing with Waltman)).

My own view is that the system benefits from letting these issues play out in the courts; others may believe that legislative "quick fixes" are preferable.

V. Conclusion

The civil tax penalty structure should be reassessed; I hope the Committee sees the project through to conclusion. Above all, I think it is critical that your efforts be guided by the current compliance environment. Confusion and uncertainty are the primary challenges facing the system -- reduced sanctions and simplified penalties should be the order of the day.

Chairman PICKLE. I thank you.

Mr. Kenneth Gideon. I understand Mr. Goldberg and Mr. Gideon are both former chief counsels for the IRS.

Mr. GIDEON. That is correct, sir.

Chairman PICKLE. We are glad to have you here with your years of experience. Your testimony is important to us.

Mr. Gideon, if you will proceed.

STATEMENT OF KENNETH W. GIDEON, FRIED, FRANK, HARRIS, SHRIVER & JACOBSON, WASHINGTON, DC

Mr. GIDEON. I will be very brief because so much of this has been covered before. Let me stress, however, that I am testifying as a has been and as an individual and not on behalf of my law firm or any other organization today.

I have two major points, major point one, we have got to quit scoring revenue for penalty increases. I think that is how we got to where we are. It is simply too easy, if we get a positive revenue estimate out of a penalty provision and put it in the code.

Now, we all did this with good intentions and we had the right idea but I really don't think we will succeed in achieving a stable and just penalty system if the pressures of raising revenue are allowed to intrude on the penalty process.

No. 2, I think that we can do a great deal to rationalize the penalty system that we have now. Basically, we have got to make it make sense in terms of tailoring the size of the penalty to the offense involved. While there are many examples, the classic example is the fact that the substantial understatement penalty now is levied at a price that is 500 percent of the rate of the negligence penalty.

Now, that is ridiculous because in terms of the proportionality and the seriousness of the offense, it ought to be just the reverse, if we are going to preserve any kind of reasonable relationship between the offense and the penalty rate.

Another example, I think, that has been alluded to today is in the information penalty area. We badly need to avoid the kind of an anticompliance situation that exist at various places where you are just going to pay the same penalty no matter if you made a foot fault, you filed a day late as if you filed a year late or if you never file at all.

The objective and compliance penalties and information penalty is to get the information in and file the form, and there has to be a way of rationalizing the system so that the penalty structure rewards you for compliance, as opposed to giving you a permanent disincentive not to comply once you have gone over the first line. I have a lengthy statement that goes into all of this in more detail, but I think you have heard an awful lot of it. I will be quiet now.

[The statement of Mr. Gideon follows:]

STATEMENT OF KENNETH W. GIDEON
BEFORE THE
SUBCOMMITTEE ON OVERSIGHT
OF THE
COMMITTEE ON WAYS AND MEANS
March 31, 1988

Mr. Chairman, I am pleased to appear today to support a thorough review of civil tax penalties. My practice experience includes representation of clients large and small before all levels of the Internal Revenue Service and the three courts which review its determinations as well as service as the Chief Counsel for the Internal Revenue Service approximately five years ago.

That practice experience has convinced me that civil tax penalties are both an appropriate and effective compliance tool. However, recent legislative enthusiasm for penalty increases has resulted in a substantial expansion in the number of penalty provisions as well as penalty coverage and severity. This enthusiasm has, I fear, been generated more by the "quick-fix" revenue estimates such increases have provided than by a careful consideration of how such increases would enhance compliance. The revenue-driven penalty system we have constructed in recent years lacks coordination, does not adequately distinguish between negligent or intentional noncompliance and good faith disputes and errors, and, perversely, may punish the latter more severely than the former. Worse still, the penalty structure is now so complex that much of its potential deterrent force is lost because taxpayers can not comprehend the minutiae of more than 150 separate penalty provisions.

This is not to say that you should return to the penalty structure of 1980 or before. There are many worthwhile features of the current structure worthy of retention. However, I believe that penalties should be judged based on their potential for enhancing compliance, not raising revenue. Indeed, I believe that when penalties are forced to do double duty as compliance enhancers and revenue raisers, the revenue objective soon overwhelms the compliance objective.

As a case in point, I offer the history of the substantial understatement penalty, section 6661. Originally conceived as a low-rate (say 5%), "no fault" audit charge, its objective was to provide a "downside" cost for noncompliance whatever the reason. As enacted, it contained exceptions for "substantial authority" and "disclosure" and, largely for revenue reasons, was imposed at 10%. (Given the fact that the negligence penalty was then only 5%, this penalty, from a compliance standpoint, was either too high or the negligence penalty was too low if the severity of the penalty should vary with the severity of the noncompliant behavior.) Perhaps the ultimate irony in this penalty's career, however, was its increase to 20% then 25% at the time when Congress was exterminating the shelters which prompted its enactment by adding the passive loss rules to the Code. Worse yet, the last increase was retroactive and hence could not possibly deter conduct which had already occurred. The penalty also bears nondeductible interest from the due date of the return (not from the date of assertion). It can therefore easily increase the cost of inadvertent noncompliance or even a good faith contest by well in excess of 35% if assessed at the end of the three year limitations period.

It is doubtful that this kind of geometric increase in severity can be justified based on compliance needs - nor was there even much pretense in that direction at the time of the last increase. It was a revenue raiser in a budget reconciliation.

Accordingly, I conclude that if Congress is serious about penalty reform, the first requirement is that Congress in effect "take the pledge" not to meet revenue requirements with penalty provisions. Increasing the burdens of noncompliant taxpayers will always appear to be a politically attractive proposition in the abstract by comparison to a general tax increase or repeal of a favored deduction.

I believe, however, that this view is tenable only as an abstraction. Given the complexity and novelty of much of the Code, it is predictable that there will be much inadvertent and good faith noncompliance during the next few years. Do we really want to increase the burden of such a "miss" by 35%? Is it appropriate in the post-shelter environment we now face? Are taxpayers likely to perceive such a penalty as fair or appropriate? What will be the effect on their future behavior if they believe the penalty was excessive or unfair?

These are the appropriate questions. I suggest that when penalties are evaluated as revenue raisers, such questions are often not even asked. Therefore, I have little hope that we can truly rationalize the penalty system to serve compliance ends so long as it is revenue-driven. It is simply too easy to score a little revenue by penalizing some newly defined taxpayer sin or to increase the toll on those already branded sinners. There is, of course, a political limit to all this -- those who think otherwise have forgotten that tax revolt was a mainspring of the American Revolution. That political reaction will not be long in coming if taxpayers perceive the penalty system as a "gotcha" system of concealed tax increases levied on those unlucky enough to be selected for audit, rather than as appropriate additions for avoidable and recognizably wrong actions.

Whether the fact of this hearing indicates that we are approaching that limit, I leave to your political judgment. Whatever the motivating reasons, I welcome this level of attention to penalties and I particularly applaud the effort to effect to examine penalties generally rather then simply focusing on particular provisions.

What's wrong with the current system? First, it is too complex. There are too many penalty provisions, with too many intricate special rules. Second, it is not integrated. Taxpayers are often faced with three and even four penalties assessed on the same transaction. Third, penalty severity often bears no relationship to the seriousness of the noncomplaint behavior. The revenue-focus of recent enactments has led to increases in widely applicable penalties while less frequently imposed penalties such as negligence have largely been ignored. This has produced the anomaly that our sanction for the mildest form of noncompliance -- substantial understatement -- is now 500% of the penalty level for negligent or intentional noncompliance. Fourth, in my judgment, penalty levels are generally too high for less serious noncompliance. The increase in penalty amounts coupled with the fact that deficiency interest is no longer deductible has now dramatically increased the costs of being wrong for the slightly more than 1% who are audited -- and the most dramatic increases have been levied on the least severe forms of noncompliance. Finally, if our goal is compliance not revenue, the Internal Revenue Service has insufficient authority to abate penalties in return for compliance.1/

1/ As an example of this last point, consider the information return penalties - typically $25 for failure to issue a required Form 1099. If compliance is the objective, the goal is to get the form filed, not collect $25. An abatement provision which would reduce the penalty significantly upon prompt compliance after notice would promote form filing.

Development of a sensible penalty system requires development of an underlying consensus on why we have penalties. There are at least four basic justifications for imposition of penalties. These are:

1. Punishment - Under this approach, the penalty is a direct sanction for wrongdoing. It stigmatizes behavior as improper. It extracts a cost from the violator for the misdeed.

2. Deterrence/compliance - Under this approach, the objective is to prevent future noncompliance by the violator -- and, perhaps is even more importantly, to dissuade others from becoming violators. Stated positively, we wish to encourage compliant behavior.

3. Cost recovery - Under this approach, the Government seeks to recover its increased costs arising from noncompliant behavior from the person causing the cost to be incurred.[2]

4. Revenue-raising - Penalties can be imposed to raise money.

It may well be that the justification varies with the particular conduct at issue. Some charges, which I suggest should not be labeled "penalties" may be appropriately imposed as cost recovery measures on those taxpayers whose conduct requires the Government to incur an additional cost. Collection charges or fees for missing an interest payment on Schedule B might appropriately fall in this category. However, true penalties should be aimed at enhancing compliance. Insistence that penalties raise revenue (i.e., that they be regularly imposed and collected) may often be incompatible with effective use of such penalties to enhance compliance. Indeed, to the extent a penalty provision is effective as a compliance tool, receipts from the provision should fall.

What are the characteristics of a good penalty system?

First, it should be compatible with existing conditions. A system of voluntary compliance is dependent on taxpayer goodwill. Taxpayers in my judgment do not perceive deficiency interest charges as unfair because they understand that they are reasonable charges for the use of money. Similarly, I think a low rate audit charge might receive similar acceptance. I question, however, whether a high rate penalty (as opposed to a low rate, no fault audit charge) will be perceived as fair if applied to good faith or genuinely inadvertent noncompliance. In an environment where the basic rules have changed as fundamentally as they have in the 1984 and 1986 Acts, I believe high rate penalties for such minimal misconduct are particularly inappropriate.

Second, penalties should be targeted to noncompliance and should vary in severity with the severity of the noncompliant conduct. There should be a clear progession in severity, for example, in the application of penalties to simple errors, negligence (in the sense of an absence of due diligence to comply), intentional disregard of rules, and fraud (which I view as concealment or deception). In this connection, investigation of the integration of criminal law sanctions through the notion of "lesser included offenses" bears consideration here both as a way of assuring that the penalty sanction is proportionate to the severity of the noncompliant behavior and as possible answer to the problems of pyramiding penalties inherent in the current system. Similarly, criminal law concepts under which the severity of the sanction varies in proportion to the magnitude of the harm and whether the behavior is repetitive deserve consideration in your review.

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[2] While many of our current penalties have this as a justification, there has been no systematic effort to relate charges and costs. In addition, in many instances such as late payment, the charge might actually be better received by taxpayers if it were not labeled a penalty at all but a late payment charge and imposed at rates conforming to commercial practices.

Third, penalties should not be imposed on good faith disputes. In this connection, the disclosure provisions of section 6661 deserve particular attention and possible expansion. It is difficult to perceive why a taxpayer willing to identify his disagreement to the Internal Revenue Service should be subjected to a severe sanction[3]

Fourth, many provisions now labeled penalties would probably provoke less controversy if they were "de-stigmatized," (i.e., labeled "user fees" or "late charges") and imposed in a manner which bears some relationship to the Government's costs. For example, the so-called 100% penalty imposed business officials who fail to withhold has now evolved into a back-up collection device. Its administration and the courts handling of it would be improved if it were more appropriately labeled and appropriate subrogation were provided.

Finally, penalties should enhance the general perception of the fairness of tax administration. This goal is advanced when recognizably bad conduct such as fraud or negligence bears a surcharge. High rate penalties on good faith or inadvertent noncompliance, however, have precisely the opposite effect. Admittedly, the most difficult task you face is to draw appropriate distinctions between good faith mistakes and aggressive noncompliance. I believe, however, that practical and workable solutions can be achieved if a compliance enhancement objective (rather than a revenue raising objection) is adopted.

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[3] Disclosure is not a complete answer because a taxpayer may believe his position is so clearly right that disclosure is not required.

Chairman **Pickle**. Your statement and Mr. Goldberg's statement will be included in its entirety.

You made two good points. I appreciate your summary. I want to ask a question about that.

Now, Mr. Hopkins.

STATEMENT OF BRUCE R. HOPKINS, BAKER & HOSTETLER, WASHINGTON, DC

Mr. **Hopkins**. Yes, Mr. Chairman. Good afternoon. I, too, am appearing in my own capacity and not on behalf of the firm or on behalf of any particular organization. I have a statement that I would ask be included in the record.

I have been asked to approach this matter of penalties from the standpoint of tax exempt organizations. This is somewhat of a unique aspect of this area because traditionally the enforcement mechanism in the exempt organizations area has been revocation of tax exempt status, However, in recent years, Congress has moved beyond that into a series of penalties and taxes and additions to taxes in an effort to bring sanctions to bear in this area in the form of both penalties on nonprofit organizations and their managers involved, in lieu of revocation of exemption.

More frequently, penalties are being imposed on the individuals themselves that were involved in a particular offending act as opposed to the organizations themselves. As a consequence, we have in the law today 32 separate penalties and these are summarized in my statement, that are specifically applicable in the tax-exempt organizations context. These penalties include the excise taxes in the private foundation area.

As to the matter of uniformity in the exempt organizations area, it is rather non-uniform. There are penalties in some contexts that are $10 a day and in some contexts that are $1,000 a day. I have indicated in my written statement that perhaps some uniformity ought to be introduced in this area, so to make the penalties common across the board so a non-profit organization could understand them better.

More specifically as to some of the recommendations I have, I have been particularly struck, as I watched the subcommittee's hearings over the past year, taking a look at legislative and political campaign activities, fund raising, unrelated business, and so forth, noting the tremendous absence of data that the Internal Revenue Service has and the subcommittee has about nonprofit organizations.

By and large, that stems from the fact that the information and tax returns are not being filed and not being properly prepared or being filed late. One of the points I have addressed in my statement is whether the penalty structure ought to be revised to induce greater compliance with filing, both in terms of completeness of the returns and timeliness of the returns. This would enable the Service and the subcommittee to have the data that it needs to legislate in this area on a timely basis.

Being someone who represents non-profit organizations almost exclusively, I am not particularly comfortable in making that recommendation. At the same time, the compliance problem is a very serious one and something needs to be done to induce greater filing compliance in this area.

The second comment I would make pertains to the fund raising disclosure rules enacted just last year. As you recall, this is the section that imposes fund-raising disclosure requirements on noncharitable organizations seeking contributions. Probably the greater abuses exist in situations where charitable organizations seek moneys that are not deductible, and I would urge the subcommittee to take a look at the situations where that is occurring.

They were summarized in the Ways and Means Committee report accompanying this particular provision. Possibly, this penalty should be expanded to include situations where donors are being consistently misled into thinking deductions are available when, in fact, they are not.

As to the legislative expenditure penalty enacted last year, I suggested in my statement that it be restructured because as is presently written, it applies only after the exemption is also to be revoked. I submit that that particular penalty ought to be structured in such a way that it serves as a warning, so that penalty is levied but the organization continues to retain its tax-exempt status, and so the revocation would occur only if there is a further violation.

Finally, I am suggesting in my statement that the so-called private inurement rules that underlie several categories of tax-exempt status be underlain with a penalty similar to the one enacted last year with respect to excessive lobbying. Some of the more serious problems in the exempt organizations area occur with respect to a specific individual's abuse, in relation to a tax-exempt organization that he or she founded, as a use of it for their private gain. It seems to me that, rather than revoke the exemption of the organization which may be providing beneficial programs, a penalty ought to be levied on the individuals that have manipulated the tax-exempt organization for their private ends.

Thank you, sir.

[The statement of Mr. Hopkins follows:]

Statement of
Bruce R. Hopkins
Baker & Hostetler
Washington, D.C.

Mr. Chairman and other members of the Subcommittee on Oversight of the House Committee on Ways and Means, thank you for inviting me to present testimony as part of the series of hearings, commencing with this one, to review the structure, application, fairness, and effectiveness of the civil penalty provisions contained in the Internal Revenue Code ("IRC").

As requested, my testimony is confined to the law and issues in this context as they apply to tax-exempt organizations.

Introduction

Tax-exempt organizations, despite the term, are not spared federal income taxation, nor are they immunized from federal tax civil penalties and additions to tax. In some instances, these sanctions are also applicable to directors and officers of tax-exempt organizations, and others.

In the broadest sense, all of these items -- taxes (usually excise taxes), penalties, and additions to tax -- are "penalties." This generic definition of the term will be used throughout.

At the present, there are 16 federal income or excise taxes that are specifically applicable in the tax-exempt organizations context. (Most of these excise taxes are pertinent only to private foundations.) In addition, there are 16 civil penalties (levies explicitly denominated as penalties) that are specifically applicable in the tax-exempt organizations setting.

There are many other taxes, penalties, and additions to tax that are applicable to tax-exempt organizations and associated individuals, although they also have much broader applicability. For example, a charitable contribution of property, with the deduction based upon a "valuation overstatement" (IRC § 6659(c)), can lead to an addition to tax (IRC § 6659(a)) and a very high rate of interest for "substantial underpayments" of tax (IRC § 6621(c)). Likewise, a frivolous tax-exempt organizations "issue" can entail the addition to tax for negligence and fraud (IRC § 6653(a)(2)) and, if Tax Court litigation is used to advance a groundless position or to achieve delay, special damages to the United States (IRC § 6673).

An inventory of the taxes and civil penalties that are specific to tax-exempt organizations follows this statement.

Historically, the regulatory sanction in the tax-exempt organizations context was revocation of tax exemption -- a stark, all-or-nothing approach. This dramatically changed in 1950, when Congress enacted the income tax on unrelated business activities. Again, in 1969, Congress enacted a battery of penalties in the form of excise taxes applicable to private foundations. And, the

Revenue Act of 1987 brought a panoply of taxes and penalties in the exempt organizations context, in subjects ranging from lobbying and political campaign activities to fund-raising disclosure.

These and other enactments reflect two trends in the approach by Congress toward regulating the affairs of tax-exempt organizations: (1) greater reliance on excise taxes and civil penalties (rather than loss of exempt status) as sanctions and (2) a greater willingness to apply taxes and penalties to the individuals involved (who, after all, are the ones that cause an organization to act). Usually, this approach is one that is easier to administer and is based on objective standards.

Response to Press
Release Questions

The purpose of the tax penalty system in the tax-exempt organizations setting should be to induce and maintain compliance with the substantive rules to which they relate. That is, these penalties should not be regarded (and, for the most part, I do not believe they are) as revenue-raising mechanisms.

In the testimony below, I have endeavored to address the issues in the tax-exempt organizations context that the Subcommittee should consider when evaluating the current penalty structure, as well as suggestions for reforming that structure.

In the exempt organizations setting, the penalties are not consistent, and they are not always fair and equitable. In some instances, the penalties are not realistic in relation to the related offense or are not an effective deterrent to noncompliance.

I believe that the Internal Revenue Service ("IRS") is generally fairly administering the current penalty provisions. This is particularly true with respect to the private foundation penalties (excise taxes), which are quite stringent, yet are made palatable and practical as the result of the quality of this IRS enforcement. However, IRS enforcement of the penalties underlying the requirement to file annual information returns (principally Form 990) may be less than what is required, to cause compliance with the rules and in relation (out of fairness) to those organizations that do properly comply.

Conclusions

My conclusions as to the range of penalties in the context of the federal tax law as it applies to tax-exempt organizations are that (1) in general, the penalty system is fair and reasonable, (2) the private foundation excise tax structure can be onerous and even severely punitive, although this situation is largely being ameliorated through amply fair interpretation of the rules by the Treasury Department and the IRS, (3) the penalty rules underlying the fund-raising disclosure provision (IRC section ("§") 6113) should be eased (and the substantive rules revised), (4) the penalty rules associated with the annual information return filing requirements (IRC § 6033) may have to be strengthened, to induce compliance, and (5) the "private inurement" rules (of IRC § 501(c)(3)) should be underlain with a series of penalty taxes.

In considering revision of the penalty structure in the tax-exempt organizations law context, a possible guiding principle is uniformity. For example, it seems to me that the penalty for failure to timely file a complete annual information return (IRC § 6652(c)), the penalty for failure to make the fund-raising disclosure (IRC § 6710), and the penalty for failure to disclose the availability of certain government services or products (IRC § 6711) could be the same. (The first penalty generally is $10 per day, while the other two penalties generally are $1,000 per day.) Or, at least the initial penalty could be identical -- such as $100 for each day of violation.

However, if this Subcommittee believes that the $10 per day penalty with respect to returns is appropriate, perhaps it could recommend that these other two penalties be reduced to $10 per day. This would be progress toward uniformity, in that the penalty for not making annual returns available for public inspection (IRC § 6652(c)(1)(C)) and for not making applications for recognition of exemption available for public inspection (IRC § 6652(c)(1)(D)) is also $10 per day.

As discussed more fully below, an increase in the penalty for failure to timely submit a complete annual information return may be required, to stimulate proper compliance. A possibility would be creation of a penalty in this context that is analogous to the substantial understatement of liability penalty (IRC § 6621(c)), to correlate the penalty with the magnitude of the infraction.

Annual Reporting

The statutory law of tax-exempt organizations has evolved rapidly in recent years -- and the process is continuing.

Looking back just a few years, Congress has legislated in such exempt organizations' areas as lobbying, political campaign activity, fund-raising, partnership involvements, and sales-leasebacks. Considerable alternations in the unrelated income rules may be the next wave of law change for exempt organizations.

Throughout all of this, past and present, there has been constant repetition of this message: the IRS lacks adequate information about the activities, financial and otherwise, of tax-exempt organizations. That message was heard, for example, time and again during this Subcommittee's hearings last year on possible revisions of the unrelated income law.

One of the principal ways in which the IRS acquires data about exempt organizations is by means of the annual information returns. These include the Form 990 for most nonprofit organizations and Form 990-PF for private foundations.

This apparently is not working particularly well. Part of the problem lies in deficiencies in the returns and the accompanying instructions. Part of the problem also lies in the fact of noncompliance or poor compliance with the filing requirements. As to the latter, perhaps an increase in the penalty for non-filing or incomplete filing is unavoidable.

The present penalty, for failure to file an annual information return or failure to include required information on a return or to show the correct information, is $10 for each day the failure continues, payable by the organization, up to, as to any one return, the lesser of $5,000 or 5 percent of the gross receipts of the organization (IRC § 6652(c)(1)(A)). A similar penalty can be applied to an organization's managers ((IRC § 6652(c)(1)(B)).

As a practicing lawyer whose client base principally consists of tax-exempt organizations, I am not comfortable proposing higher penalties for failure to file complete annual returns. However, I believe that the independent sector and the public will be better served when Congress and the IRS has better data about them -- and that greater filing compliance is necessary to produce that data.

Thus, is essential to the tax-exempt organizations community that organizations' annual information returns be prepared in the proper manner and filed on a timely basis.

The purpose of the penalty structure accompanying the return filing requirement is, and should be, to induce compliance, rather than raise revenue. Specifically in this context, I note that in the Subcommittee's press release dated March 7, 1988, it is stated that the "current tax penalty system is designed to improve taxpayer compliance and to deter specific forms of behavior by penalizing those who do not conform to the requirements of the laws relating to Federal taxes."

The penalty that applies where there is a failure to provide or show correct information on an information return (IRC § 6652(c)(1)(A)(ii)) should give the IRS greater ability to more selectively levy the penalty, in an effort to secure compliance with the specific return requirements.

Nonetheless, the penalty structure should be reviewed, to determine if it is in fact producing adequate compliance. It may well be that the penalty will have to be increased, possibly followed by loss of tax-exempt status for ongoing noncompliance, to upgrade adherence to the filing requirement.

If an increase in the penalty is deemed necessary, I suggest that the effective date of the increase be preceded by a mailing to the tax-exempt community by the IRS explaining the filing requirements. This mailing could be akin to Notice 835, which the IRS recently distributed to explain the 1987 law changes affecting tax-exempt organizations. I also suggest that Congress enact a short amnesty period, to run before such an effective date, allowing organizations that have not been filing returns to file past returns without penalty.

In this context, Congress should consider whether the revenue amount filing threshold (presently $25,000) (IRC § 6033(a)(2)) should be increased. This would enable the IRS to receive and focus on the most important returns. The filing threshold could be increased to $50,000 or even $100,000 (the latter in conformance with the threshold for activation of the IRC § 6113 fund-raising disclosure rule).

Fund-Raising Disclosure

The fund-raising disclosure rules, embodied in IRC § 6113, were enacted last year to reduce the likelihood that a taxpayer will deduct a contribution made to a noncharitable, tax-exempt organization. Most members of the general public do not appreciate the distinctions between categories of exempt organizations and thus are likely to innocently misunderstand the deductible giving rules, claiming a charitable deduction for gifts made to what is, in fact, a noncharitable entity (usually, an IRC § 501(c)(4) social welfare organization). Therefore, the mandatory disclosure rule in this context is appropriate.

However, the penalty accompanying the disclosure rules is too stringent. This penalty is $1,000 for each day on which a failure to comply occurred, with an annual maximum of $10,000, payable by the organization (IRC § 6710(a)), absent reasonable cause. There are other penalties for "intentional disregard" of the rules, as to which the $10,000 limitation is inapplicable (IRC § 6710(c)).

One difficulty in this area is the fact that the IRS is giving the fund-raising disclosure rule broad applicability. The IRS interpretation, which appears in Internal Revenue Notice 88-31, is that the disclosure requirement applies to the solicitation of membership fees and dues, even though the statute (IRC § 6113 (c)(1)) explicitly speaks only of solicitations of "contributions or gifts." The IRS bases this interpretation on a reading of the commentary in the report of the House Committee on Ways and Means accompanying its version of the Revenue Act of 1987. However, in my view, this reading of the legislative history is incorrect and the better interpretation of it is that the disclosure requirement applies to "membership dues" that are in fact contributions or gifts.

Pursuant to the IRS interpretation, the fund-raising disclosure rules are applicable to trade associations, labor unions, social clubs, and the like when they solicit (sometimes monthly) dues from their members. In my view, this was not intended by Congress when it enacted IRC § 6113. If, however, that was and is congressional intent, perhaps the statute should be amended to make the point explicit.

This pertains to the related penalties. I believe the penalty for violation of IRC § 6113 should be reduced (as noted above) to $100 per day or even $10 per day, particularly if applicable to true membership dues and fees. I believe the existing penalty is unnecessarily harsh and that a reduction of it is warranted for that reason alone. (I do not understand why violation of the fund-raising disclosure rules is 100 times worse than the offense of violating the annual reporting rules.) Also, this reduction in amount would contribute to the uniformity of penalty amounts referenced earlier.

Congress should consider extending the fund-raising disclosure rule to charitable (IRC § 170(c)) organizations that solicit payments of cash or transfers of property in circumstances where the payor or transferor believes (or, worse, is led to believe) that the transaction is giving rise to a deductible charitable contribution. There are abuses in this context, most of them inadvertent, and they seem to be on the rise. The present IRS rule mandating disclosure (Rev. Rul. 67-246, 1967-1 C.B. 104) lacks a sanction and thus is largely ineffectual.

The disclosure rule, as extended, would apply with respect to events such as auctions, raffles, and dinner and theater parties. It would require the charitable organization to notify persons in advance that the payments (for items of property or tickets) are not deductible charitable gifts or, if a portion of the payment is a gift (such as the amount paid that is in excess of the fair value of a dinner or theatrical performance) what portion is properly claimed as a deductible charitable gift.

Lobbying Restrictions

The enactment of the Revenue Act of 1987 brought a penalty, in the form of an excise tax on charitable organizations and in some instances their managers, for engaging in attempts to influence legislation to the extent that the tax-exempt status of the organization is forfeited (IRC § 4912). This penalty consists of a 5 percent tax on the organization that makes excessive legislative expenditures and a like tax on the organization's directors and officers who, without reasonable cause, willfully cause the organization to lose its tax exemption because of an impermissible extent of legislative activities. However, this penalty structure is inapplicable to those public charities that have elected under the "safe harbor" rules of IRC § 501(h).

The problem with this penalty is that it is levied in addition to loss of the organization's tax-exempt status. That is, there is no warning penalty, no opportunity for an organization to first incur a penalty and cease the offending legislative activity, without losing tax exemption. This approach is unduly harsh for three reasons.

One, the standard for defining acceptable and excessive attempts to influence legislation remains very vague -- the "insubstantiality" test of IRC § 501(c)(3). Second, private foundation and electing public charities are allowed, when engaging in legislative activities that start to go beyond the bounds of what is permitted, to pay a penalty and correct the matter without loss of exemption. In these instances, private foundations pay the penalty (initial excise tax) imposed by IRC § 4945(a) and electing public charities pay the penalty (initial excise tax) imposed by IRC § 4911(a)(1). Third, a charitable organization that loses its tax exemption because of attempts to influence legislation is not allowed to convert to a tax-exempt (IRC § 501(c)(4)) social welfare organization (IRC § 504).

Therefore, I recommend that the IRC § 4912 penalty be revised to build into it a warning penalty. This could be done by (1) making the 5 percent tax on charitable organizations imposed without corresponding loss of tax exemption, at least on a one-time basis, (2) using the two-tiered tax structure approach, such as that used in the case of political campaign activities by charitable organizations (IRC § 4955), without corresponding loss of tax exemption, or (3) extend the elective rules (of IRC § 501(h) and 4911) to all public charities.

The virtues of this latter suggestion include the far more precise definition of permissible legislative activities that is contained in the elective rules and the warning penalty of the 25 percent excise tax of IRC § 4911 (a)(1). (Such an extension of the elective rules should be predicated only upon the adoption of fair and reasonable regulations to accompany these rules.)

Private Inurement

Charitable organizations (those described in IRC § 501(c)(3)) and several other categories of tax-exempt organizations are forbidden from engaging in actions constituting "private inurement." That is, their tax-exempt status is lost if their net earnings inure to the benefit of individuals in their private capacity.

There have been many court opinions in recent years involving violations of the private inurement doctrine. These cases have been particularly prevalent with respect to certain religious organizations, particularly instances of the use of the so-called "personal church." These occasions of abuse (many of which are well-publicized) adversely affect all tax-exempt organizations, by tainting the public's perception of them.

Consideration should be given to the enactment of a penalty or penalties to underlie the private inurement doctrine. The applicability of these penalties should be on the individual or individuals that caused the act of private benefit. The penalties would be even more effective if they embodied the concept of a warning penalty, as discussed above in connection with the sanctions imposed in the legislative activities context.

There is discussion from time to time about extending some or all of the IRC Chapter 42 rules, applicable to private foundations, to public charities. Thus, in an effort to combat private inurement, Congress could extend the IRC § 4941 self-dealing rules to all charitable and other tax-exempt organizations. However, I do not believe these rules would work when applied to all organizations (including public charities) and do not endorse that proposal. Instead, I recommend that consideration be given to creation of a tax penalty in enforcement of the private inurement rules akin to the tax penalty enacted last year to accompanying the legislative activities prohibition (albeit with the modifications suggested earlier).

Again, I appreciate the opportunity to appear before the Subcommittee today.

I would be pleased to answer any questions the members of the Subcommittee may have.

EXEMPT ORGANIZATION EXCISE AND PENALTY TAX PROVISIONS

Code Section	Description of Activity	Penalty Imposed On		
		Individuals*	Exempt Organizations	Both
507	Termination of private foundation status		X	
511	Unrelated business taxable income		X	
527	Political organization taxable income		X	
4911	Excess lobbying expenditures		X	
4912	Disqualifying lobbying expenditures			X
4940	Private foundation investment income		X	
4941	Self-dealing	X		
4942	Failure to distribute income		X	
4943	Failure to divest excess business holdings		X	
4944	Investments in enterprises jeopardizing charitable purpose			X
4945	Taxable expenditures			X
4948	Foreign private foundation investment income		X	
4951	Self-dealing with black lung benefit trust			X
4952	Black lung benefit trust taxable expenditures			X
4953	Excess contribution to black lung benefit trust	X		
4955	Political expenditures of 501(c)(3) organization			X
6651	Failure to file tax return with with respect to or to pay tax due on UBTI		X	
6652(c)(1)(A)	Failure to file exempt organization information return or to include requisite information		X	
6652(c)(1)(B)	Failure to comply with IRS demand to file information return or furnish requisite information	X		

* As appropriate, the term "Individuals" includes disqualified persons, organization managers, directors, trustees, and officers.

Code Section	Description of Activity	Penalty Imposed On Individuals*	Exempt Organizations	Both
6652(c) (1)(C)	Failure to make annual information returns publicly available	X		
6652(c) (1)(D)	Failure to make application for recognition of exemption publicly available	X		
6652(c) (2)(A)	Failure to file return regarding liquidation, dissolution, termination or substantial contraction or to file charitable trust return		X	
6652(c) (2)(B)	Failure to comply with IRS demand to file return on termination of exempt organization or to file charitable trust return	X		
6655	Failure by an exempt organization to file estimated tax with respect to UBTI or investment income tax		X	
6684	Assessable penalty for prior liability for Chapter 42 tax or for willful and flagrant violation leading to Chapter 42 tax	X		
6685	Assessable penalty for willful failure to make information returns and applications for recognition of exemption publicly available	X		
6710	Failure to disclose the nondeductibility of contributions		X	
6711	Failure to disclose the availability of information or service from federal government		X	
6721	Failure to file information return upon the disposition of certain donated property		X	
6722	Failure to provide payee statement upon the disposition of certain donated property		X	
6723	Failure to include correct information on return or a payee statement upon the disposition of certain donated property	X		
6852	Flagrant political expenditures by a 501(c)(3) organization			X

David L. Marshall, an associate at Baker & Hostetler, prepared this table of IRC provisions.

Chairman PICKLE. Thank you, Mr. Hopkins.

Mr. Hopkins, have you seen the generally agreed-upon starting points, that the subcommittee recommended in the tax-exempt organization area?

Mr. HOPKINS. In the unrelated income area?

Chairman PICKLE. Yes.

Mr. HOPKINS. Yes, I have.

Chairman PICKLE. We are recommending increased compliance in the data reported and more detailed types of information on the form 990 and 990–T's. We think that, if we have more data, more information from those forms we would better know how to handle it. That will be part of the overall measure, if one is advanced. There has been no vote, but we are saying that this is the starting point.

Do you think, in general, that such a starting point is a good beginning?

Mr. HOPKINS. I think it is a good beginning, sir. As I indicated in my testimony, the problem is twofold. One aspect is with the return and the instructions. They are confusing and, in some cases, incomplete. On the other side of the coin is the compliance problem.

I have suggested in my testimony that, if there are to be revisions in this area, that once they are enacted, the information be well-publicized, just like the Service did back in January with Publication 835 dealing with the 1987 act revisions.

I propose publicizing all of the new filing requirements and an amnesty for a period of time so all of the organizations that have not been filing come into compliance. After that, perhaps, there should be a stiffer penalty to induce compliance with the rules because some organizations are simply being lackadaisical in the way they are approaching these requirements.

Chairman PICKLE. The purpose of this hearing is not to get into the UBIT area. If I thought we could address abuses by merely prosecuting or filing charges against an individual in some big tax-exempt organization, that might be approached, but it is more difficult than that. We are dealing with big universities and big charities.

I hear you and I am not going to prejudge any of these things, but just as you have testified the need for more data, I want you to serve notice to that tax-exempt Independent Sector that we want more information and cooperation, period.

Mr. HOPKINS. They are not a client. They are a friend and I will pass that along.

Chairman PICKLE. You can repeat it twice.

Mr. HOPKINS. I will do that.

Chairman PICKLE. Now, Mr. Gideon, I agree with you that we shouldn't have revenue as the motivation for these penalties. I don't know that we have got any law or any place where we have said that we are going to pass this penalty in order to raise revenue. We don't say that, that I know of, but it may be.

Mr. GIDEON. We came awful close, I think, in the 20 to 25 percent increase in section 6661. It got put in in a budget reconciliation. And——

Chairman PICKLE. You make a good point there.

Mr. GIDEON [continuing]. If you didn't score penalty revenue, that motivation at least would disappear.

Chairman PICKLE. All right. I think you made a good point there. I don't know where that came from. I plead ignorance, of course.

Mr. GIDEON. I understand where it came from. It is part—I would like to discourage them, too.

Chairman PICKLE. I understand what you are saying on it. Now, in general, do you as a panel think that we need to simplify or try to codify these penalties and reduce them? Could we, for instance, have a system where we had instead of 150, we had 25 penalties and could they be categorized as penalty A, B, C, civil penalties right on down the line? When you come to the enforcement, you say if you don't comply, it will be penalty A and so forth.

Can you simplify it that much?

Mr. GIDEON. I think that you can come awful close to that. I think, for example, and ascending hierarchy or if you want to use kind of the prosecutor's line, lesser included offense type concept where basically we have a hierarchy starting at the bottom with substantial understatement and going then up to something like negligence and maybe making intentional disregard of a very clear regulation, maybe a higher sanction and finally fraud.

And saying to the IRS, now, you can charge the highest level of this that you think is appropriate, and if in fact the proof shows ultimately down the line that what you should have gotten was, you said it was intentional and proven that it is simply wrong, but not intentional, you will get the lesser penalty but you won't get two or three penalties.

I mean there are frequently situations right now, and I realize they are not the most sympathetic folks in the world, but folks who mistakenly invested in some of these shelters in the past, rather frequently are faced with paying four or five of these penalties because you can get there on the same transaction.

I don't think that encourages the right attitude. I think that what we ought to have is a sliding scale, based on the severity of the offense and we ought to assess one penalty for that specific offense. What we can get it down to, you know, category A, B, C, or D, I don't know, but I know we can better integrate it than it is now.

Chairman PICKLE. That would be our goals and our hope.

Now, some people have argued that IRS uses the threat of additional penalties as a tool to pressure taxpayers into accepting some kind of an unfavorable settlement.

To what extent, in your opinion, are civil penalties being used by the IRS as sort of a negotiating tool? Is that existent?

Mr. GIDEON. As a realist, I would have to say yes. Also as a realist, I would like to say that it is not—I am not all together sure that it is a completely bad thing. I think that to threaten a penalty that is unjustified is a bad thing and is an abuse.

I don't think that happens very often. But, on the other hand, in facing one of these complex tax shelter situations, I think to fail to take into account in reaching a settlement, for example, with an appellate conferee that this conduct was probably subject to a penalty would be inappropriate. To take that amount into account along with everything else in reaching the final amount of settlement, I can see how people might be unhappy with that.

On the other hand, I am not sure you really want to stop the Service from doing it.

Mr. GOLDBERG. I would like to echo his sentiments.

Chairman PICKLE. As a followthrough, do you believe the flexibility given to the IRS official in assessing and negotiating settlements has been an instrument or tool that has been fairly used by the IRS?

Mr. GIDEON. I think that that is probably the most successful part of our tax system. As a matter of fact, I think it allows, frankly, the system to take into account particular facts and circumstances in a way that I don't think we are ever going to succeed in making rules fine-toothed enough to resolve.

I think the settlement process, particularly in the appeals division, is a large part of what makes our system work and I don't think you want to interfere with that. I really don't.

Chairman PICKLE. Mr. Goldberg.

Mr. GOLDBERG. I share Mr. Gideon's sentiments across the board.

Chairman PICKLE. If you gentlemen have any additional statements that you would want to make in view of the fact you might have heard a lot of this testimony today and as former counsel, we would appreciate any additional statements you want to make to the subcommittee.

I appreciate your coming forth today and being so patient, to wait your turn. If we have another hearing, we will put you closer to the front. If you submit us good statements in the meantime.

I thank you. This has been a long hearing, but it has been helpful to us. This is the first in a series of statements or hearings that we will probably hold on this. Since this is towards the first of April, within the next month we anticipate—I do—that many organizations will be making general recommendations as task forces.

The Internal Revenue Service is working on a task force and maybe they will visit with you about it. I don't want to rush into this because it is far too important for that. We have got to have a Tax Code and it has got to be a happy one.

I think the people are willing to pay taxes by in large, if they feel they are paying their just portion and somebody else is not getting by without paying any. You can't blame them as a wet hen if they feel somebody is getting by without paying taxes. I think the average American wants to pay his just portion. There are always going to be penalties in some way, but perhaps we can simplify them to make it be an incentive to pay rather than a penalty if you don't.

To that extent, this committee will continue to study this issue and hope that by late fall we might have something to advance of concrete nature. I thank you for your participation and for your help today.

The committee stands adjourned.

[Whereupon, at 2:35 p.m., the subcommittee was adjourned.]

[An appendix to this day's hearing follows:]

APPENDIXES

APPENDIX A

J.J. PICKLE, TEXAS, CHAIRMAN
SUBCOMMITTEE ON OVERSIGHT

BERYL ANTHONY, JR., ARKANSAS
RONNIE G. FLIPPO, ALABAMA
BYRON L. DORGAN, NORTH DAKOTA
HAROLD FORD, TENNESSEE
CHARLES B. RANGEL, NEW YORK
ANDY JACOBS, JR., INDIANA

DICK SCHULZE, PENNSYLVANIA
BILL FRENZEL, MINNESOTA
WILLIAM M. THOMAS, CALIFORNIA
RAYMOND J. McGRATH, NEW YORK

Ex Officio:
DAN ROSTENKOWSKI, ILLINOIS
JOHN J. DUNCAN, TENNESSEE

COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
WASHINGTON, DC 20515

SUBCOMMITTEE ON OVERSIGHT

DAN ROSTENKOWSKI, ILLINOIS, CHAIRMAN
COMMITTEE ON WAYS AND MEANS

ROBERT J. LEONARD, CHIEF COUNSEL
M. KENNETH BOWLER, STAFF DIRECTOR
BETH KURTZ VANCE, SUBCOMMITTEE STAFF DIRECTOR

A.L. SINGLETON, MINORITY CHIEF OF STAFF
MICHAEL A. SUPERATA, COUNSEL TO THE MINORITY

February 19, 1988

Mr. Bryan E. Slone
Assistant to the Commissioner
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, D. C. 20224

Dear Bryan:

As you know, Chairman Rostenkowski of the Committee on Ways and Means has requested the Oversight Subcommittee to undertake a comprehensive review of the civil penalty provisions contained in the Internal Revenue Code. The request was made in recognition that the number and scope of the tax penalties have increased dramatically in recent years.

The Subcommittee is presently scheduling hearings to review the structure, effectiveness, fairness, and application of the present law civil penalties. At the conclusion of these hearings, the Subcommittee will provide a report with recommendations to the full Committee.

The Subcommittee plans to conduct the first of a series of hearings on the subject during the last week of March, 1988. As we discussed earlier, Chairman Pickle requests that the Commissioner appear as a witness at this hearing. A letter outlining issues the Chairman would like the Commissioner to address in his testimony will follow.

In order to conduct a meaningful review of the penalty system, the Subcommittee requests the following information:

1. A statistical analysis of the broad structure of the present system of civil penalties. The information should be broken down by year and include, at a minimum, the following:
    a. Code section and description of penalty.
    b. Number and dollar amount of assessments for each penalty provision.

   c. Number and dollar amount of abatements for each penalty provision.

2. The Subcommittee is interested in what effect multiple penalty assessments have on taxpayer morale and compliance. What penalty provisions are frequently combined with other penalties resulting in high cumulative total assessments? We are particularly interested in those combinations (coupled with interest) which could potentially exceed the underlying tax deficiency by 100%.

3. It is our understanding that approximately 90% of all penalties are computer generated and that roughly one half are ultimately abated. Please provide a detailed analysis of computer generated penalty assessments. The following items should be addressed:

   a. What percentage of total penalty assessments are computer generated?

   b. Which penalty assessments are computer generated? Please provide the Code section and description of the penalty, the number of assessments, and the dollar amounts?

   c. What is the average amount of a single computer generated penalty assessment?

   d. Which computer generated penalty assessments can be abated? Which assessments cannot? For each penalty that can be abated, please provide the number of abatements, the amounts, and the reason for abatement.

   e. Do the abatement ratios for computer assessments reflect a high error rate in comparison to other penalty assessments or do the figures indicate proper application of abatement criteria after initial correct assessments? Please provide an explanation

   f. What does the Service do to monitor and improve the accuracy of computer penalty assessments?

   g. What are the principal causes of error in computer assessments?

   h. Explain whether taxpayers are paying erroneously assessed penalties out of fear, misunderstanding or to avoid the trouble and expense of correcting an erroneous assessment.

i. Does the Service post-review penalty assessments to determine if taxpayers are paying erroneously assessed penalties?

j. Are penalties subject to review preferable and inherently more fair than ones generated by a computer? Please provide an explanation.

Please forward this information to the Subcommittee on a priority basis and in separate packages to facilitate our receipt. The Subcommittee will need all the above-referenced data, in any event, by March 14, 1988. Where possible, please provide information which includes the most recent data available and comparative information for the prior five years. I appreciate your attention to this matter.

Sincerely,

Beth Vance

Beth K. Vance
Staff Director
Subcommittee on Oversight

BKV/jgw

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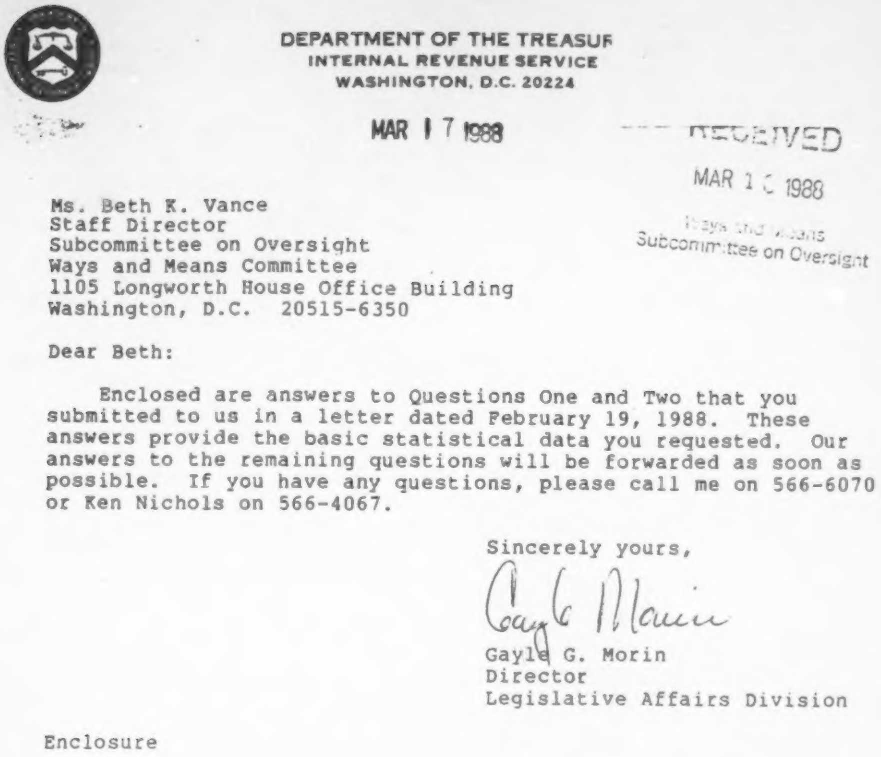
APPENDIX B



DEPARTMENT OF THE TREASUR
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

MAR 17 1988

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MAR 1[illegible] 1988
Ways and Means
Subcommittee on Oversight

Ms. Beth K. Vance
Staff Director
Subcommittee on Oversight
Ways and Means Committee
1105 Longworth House Office Building
Washington, D.C. 20515-6350

Dear Beth:

Enclosed are answers to Questions One and Two that you submitted to us in a letter dated February 19, 1988. These answers provide the basic statistical data you requested. Our answers to the remaining questions will be forwarded as soon as possible. If you have any questions, please call me on 566-6070 or Ken Nichols on 566-4067.

Sincerely yours,

Gayle G. Morin

Gayle G. Morin
Director
Legislative Affairs Division

Enclosure

QUESTIONS FROM THE HOUSE WAYS AND MEANS SUBCOMMITTEE

In order to conduct a meaningful review of the penalty system, the Subcommittee requests the following information:

1 A statistical analysis of the broad structure of the present system of civil penalties. The information should be broken down by year and include, at a minimum, the following:

a. Code section and description of penalty.

b. Number and dollar amount of assessments for each penalty provision.

c. Number and dollar amount of abatements for each penalty provision.

RESPONSE: Attached are copies of Table 14 from the Commissioner's Annual Report for the period 1978 through 1986 and a copy of the draft table for 1987. Also attached is a copy of statistics by penalty section, where identifiable, showing the information in the form requested by the Subcommittee for fiscal years 1983 through 1987.

CIVIL PENALTIES ASSESSED AND ABATED

Fiscal Years 1978-1987

(Excerpted from IRS *Annual Reports*)

Table 13.—Civil Penalties assessed and abated, fiscal year 1978 (Dollars in thousands)

	ASSESSMENTS		ABATEMENTS		NET PENALTIES	
	Number	Amount	Number	Amount	Number	Amount
INDIVIDUAL						
Delinquency	708,434	120,175	97,654	25,843	610,780	94,333
Estimated Tax	2,904,995	200,160	165,271	20,663	2,739,724	179,497
Failure to Pay	3,782,820	83,308	337,633	7,994	3,445,187	75,314
Bad Check	90,978	773	3,191	90	87,787	683
Fraud	6,736	34,025	307	2,157	6,429	31,868
Negligence	66,143	9,319	1,705	884	64,438	8,435
Other [1]	7,207	500	288	26	6,919	473
TOTALS	7,567,313	448,260	606,049	57,658	6,961,264	390,602
CORPORATION [2]						
Delinquency	80,717	65,444	18,832	44,989	61,885	20,455
Estimated Tax	195,154	99,760	18,543	48,890	176,611	50,870
Failure to Pay	166,225	43,648	39,341	28,343	126,884	15,305
Federal Tax Deposits	67	8	4	2	63	6
Bad Check	1,847	50	152	30	1,695	20
Fraud	549	16,976	33	1,118	516	15,858
Negligence	2,920	2,199	78	316	2,842	1,883
Other [3]	75	150	7	14	68	136
TOTALS	447,554	228,234	76,990	123,702	370,564	104,533
EMPLOYMENT [4]						
Delinquency	2,080,234	186,774	135,891	36,700	1,944,343	150,074
Miscellaneous	2,233	176	550	57	1,683	118
Failure to Pay	2,370,984	54,603	316,713	12,962	2,054,271	41,641
Federal Tax Deposits	2,050,925	281,876	184,487	57,257	1,866,438	224,619
Bad Check	120,796	1,538	2,402	78	118,394	1,460
Fraud	1,969	2,844	136	169	1,833	2,675
Other [5]	317	46	21	3	296	44
TOTALS	6,627,458	527,856	640,200	107,225	5,987,258	420,631
EXCISE [6]						
Delinquency	31,251	3,869	4,486	1,699	26,765	2,170
Daily Delinquency	11,003	20,895	9,681	21,030	1,322	135
Failure to Pay	33,926	1,312	7,129	732	26,797	579
Federal Tax Deposits	21,702	3,748	3,306	1,049	18,396	2,699
Bad Check	629	10	26	1	603	10
Fraud	190	367	19	36	171	331
Other [7]	58	5	4	1	54	3
TOTALS	98,759	30,207	24,651	24,549	74,108	5,658
ESTATE AND GIFT						
Delinquency	16,573	22,315	6,203	11,469	10,370	10,846
Miscellaneous	19	12	4	7	15	5
Failure to Pay	24,216	11,188	8,657	5,295	15,559	5,893
Bad Check	343	34	64	18	279	17
Fraud	17	241	2	124	15	117
Negligence	75	32	3	1	72	31
TOTALS	41,243	33,822	14,933	16,914	26,310	16,908
TAX RETURN PREPARERS' PENALTY [8]						
Failure to Sign and Failure to Provide Tax Identification Numbers	76,200	7,612	10,300	1,840	65,900	5,772
ALL OTHER [9]						
Delinquency	237,779	15,073	24,147	4,465	213,632	10,608
Failure to Pay	290,375	6,059	28,881	1,248	261,494	4,811
Bad Check	3,877	17	125	2	3,752	16
Fraud	51	45	2	1	49	44
Negligence	55	15	—	—	55	15
Other [10]	23	(11)	48	106	−25	−106
TOTALS	532,160	21,209	53,203	5,821	478,957	15,388
TOTAL ALL CIVIL PENALTIES	15,390,687	1,297,200	1,426,326	337,709	13,964,361	959,492

Notes: Amounts may not add due to rounding. With the exception of ES, penalties can apply to any tax year. Abatements can apply to any tax year.

[1] Includes Taxpayer Identification Number, miscellaneous, Failure to Report Tips.

[2] Includes Forms 1120, 990C, 990T.

[3] Includes daily delinquency, miscellaneous.

[4] Includes Forms 940, 941, 942, 943, CT-1.

[5] Includes Estimated Tax, daily delinquency, negligence.

[6] Includes Forms 1041A, 990PF, 4720, 990, 720.

[7] Includes Estimated Tax, miscellaneous, negligence.

[8] Period covered is January 1, 1978 through September 30, 1978. These penalties are from processing of individual returns only and do not reflect other penalties assessable under the Tax Reform Act of 1976, Code Sections 6694 and 6695.

[9] Includes Forms 1041, 1065, 5329, 11, 11B, 11C, 730, 2290, 4638.

[10] Includes Estimated Tax, daily delinquency, miscellaneous.

[11] Less than $500.

Table 14.–Civil penalties assessed and abated
(In thousands of dollars)

	Assessments		Abatements		Net Penalties	
	Number	Amount	Number	Amount	Number	Amount
Individual						
Delinquency	946,219	166,925	113,409	30,010	832,810	136,914
Estimated Tax	3,644,979	233,134	160,123	20,198	3,484,856	212,936
Failure to Pay	4,706,781	114,244	488,510	11,212	4,218,271	103,032
Bad Check	110,356	934	2,560	144	107,796	791
Fraud	6,818	28,086	317	2,525	6,501	25,562
Negligence	83,341	10,410	1,492	1,117	81,849	9,293
Other[1]	7,509	557	386	28	7,123	530
Totals	9,506,003	553,290	766,797	65,232	8,739,206	489,058
Corporation[2]						
Delinquency	109,224	86,552	19,939	56,308	89,285	30,244
Estimated Tax	168,965	67,687	15,430	38,576	153,535	29,111
Failure to Pay	170,044	51,024	42,635	30,075	127,409	20,949
Federal Tax Deposits	56	21	3	1	53	20
Bad Check	1,987	62	112	13	1,875	50
Fraud	467	10,307	43	976	424	9,331
Negligence	3,123	3,760	85	114	3,038	3,646
Miscellaneous	138	448	2	62	136	386
Totals	454,004	219,842	78,249	125,124	375,755	93,717
Employment[3]						
Delinquency	2,248,474	229,380	151,606	38,930	2,096,868	189,460
Miscellaneous	675	152	621	57	54	95
Failure to Pay	2,495,266	67,164	375,157	14,732	2,120,109	52,432
Federal Tax Deposits	2,620,308	348,790	209,991	67,661	2,410,317	281,129
Bad Check	120,771	1,666	2,034	59	118,737	1,607
Fraud	1,847	2,898	102	157	1,745	2,741
Other[4]	295	32	11	3	284	29
Totals	7,487,636	650,091	739,522	121,599	6,748,114	527,493
Excise[5]						
Delinquency	804,119	14,775	19,715	2,571	784,404	12,204
Dely Delinquency	16,273	36,987	12,043	28,456	4,230	8,531
Failure to Pay	737,751	5,569	37,903	1,598	699,848	3,971
Federal Tax Deposits	37,110	5,149	4,037	1,869	33,073	3,280
Bad Check	3,468	24	125	1	3,343	23
Fraud	225	1,005	25	98	200	907
Other[6]	76	44	-	-	76	44
Totals	1,599,022	63,553	73,848	34,593	1,525,174	28,960
Estate and Gift						
Delinquency	799,330	38,981	5,373	21,449	793,957	17,532
Miscellaneous	12	9	4	3	8	6
Failure to Pay	788,972	15,607	10,004	8,231	778,968	7,376
Bad Check	347	43	68	25	279	18
Fraud	5	36	1	2	4	34
Negligence	39	19	2	2	37	17
Other[6]	1	[7]	-	-	1	[7]
Totals	1,588,706	54,695	15,452	29,712	1,573,254	24,984
Tax Return Preparer's Penalty[8]						
Failure to Sign and Failure to Provide Tax Identification Numbers	22,766	5,453	19,766	2,169	3,000	3,286
All Other[9]						
Delinquency	38,710	17,491	8,872	4,219	29,838	13,272
Failure to Pay	52,896	2,153	16,954	1,078	35,942	1,075
Bad Check	541	8	54	5	487	3
Fraud	-	-	-	-	-	-
Negligence	44	9	2	2	42	7
Miscellaneous	6	2	1	[7]	5	2
Totals	92,197	19,663	25,883	5,303	66,314	14,361
Total All Civil Penalties	20,750,334	1,564,587	1,719,518	382,731	19,030,817	1,182,856

Notes: Amounts may not add due to rounding. With the exception of ES, penalties can apply to any tax year. Abatements can apply to any tax year.

[1] Includes Taxpayer Identification Number, Failure to Report Tips, Miscellaneous.

[2] Includes Forms 1120, 990C, 990T.

[3] Includes Forms 940, 941, 942, 943, CT-1.

[4] Includes Negligence and Miscellaneous.

[5] Includes Forms 1041A, 5227, 990PF, 4720, 990, 4638, 2290, 11, 11B, 11C, 720 and 730.

[6] Includes Negligence and Miscellaneous.

[7] Less than $500.

[8] Period covered is January 1, 1979 through September 30, 1979. These penalties are from processing of individual returns only and do not reflect other penalties assessable under the Tax Reform Act of 1976, Code Sections 6694 and 6695.

[9] Includes Forms 1041, 1065, and Individual Retirement Account File.

Fiscal Year 1979

Table 14.–Civil penalties assessed and abated
(Dollars in thousands)

	Assessments		Abatements		Net Penalties	
	Number	Amount	Number	Amount	Number	Amount
Individual						
Delinquency	1 030 171	222.185	129 650	48 835	900 521	173 329
Estimated Tax	3 914 428	346 043	174 116	30 071	3 740.312	315 972
Failure to Pay	4 938 220	147 214	529 956	15 839	4 408.264	131 375
Bad Check	127 142	1 054	3 773	214	123.369	840
Fraud	8.145	36 932	311	2.511	7 834	34 421
Negligence	98.262	14 379	1 809	535	96.453	13 844
Other	9 131	708	263	20	8 868	688
Totals	**10,135,400**	**780,494**	**830,878**	**98,825**	**9,285,621**	**670,460**
Corporation [2]						
Delinquency	119 720	124 682	22 640	92 197	97 080	32 484
Estimated Tax	235 930	89 672	26 015	27 332	209 915	62 640
Failure to Pay	201 778	66 985	55 038	42 389	146 740	24 595
Federal Tax Deposits	11	10	1	1	10	10
Bad Check	2.412	85	152	44	2.260	41
Fraud	552	15.811	26	374	526	15.437
Negligence	4 041	4 877	83	65	3.958	4 812
Miscellaneous	125	334	5	7	120	327
Totals	**564,580**	**382,456**	**103,900**	**162,100**	**460,680**	**140,346**
Employment [3]						
Delinquency	2 194 024	281 460	173.326	47 186	2 020 698	234 274
Miscellaneous	681	206	388	128	293	78
Failure to Pay	2.633 013	83.780	436 410	20 461	2 196 603	63.319
Federal Tax Deposits	3.012 754	469.393	256.935	105 062	2.755 819	364 331
Bad Check	130.513	1 947	2.303	77	128.210	1 870
Fraud	1.547	2.630	141	225	1 406	2.405
Other [4]	157	55	87	5	70	50
Totals	**7,972.680**	**870.472**	**880.590**	**173,146**	**7,103,000**	**686.327**
Excise [5]						
Delinquency	346 842	15 431	28 158	4 626	318 684	10 804
Daily Delinquency	14 155	29 578	13 119	32.054	1 036	-2.477
Failure to Pay	254 203	5 032	57 516	2.373	196 687	2.659
Federal Tax Deposits	54 320	9 979	4 679	2.655	49 641	7.323
Bad Check	3.572	21	191	2	3.381	19
Fraud	677	995	109	972	568	24
Other [6]	87	40	11	*	76	40
Totals	**673,866**	**61,076**	**103,783**	**42,682**	**570,073**	**18,393**
Estate and Gift						
Delinquency	18 020	50 806	5 189	39 258	12.831	11 548
Miscellaneous	10	14	1	2	9	12
Failure to Pay	27 115	23.493	16 917	17 530	10 198	5 964
Bad Check	426	68	69	30	357	38
Fraud	27	322	-	-	27	322
Negligence	47	37	4	12	43	25
Other [6]	-		-	-	-	
Totals	**45,845**	**74,740**	**22,180**	**56,832**	**23,465**	**17,900**
Tax Return Preparer's Penalty [7]						
Failure to Sign and Failure to Provide Tax Identification Numbers	25 529	3 830	24 301	4 988	1 228	-1 159
All Other [8]						
Delinquency	103 305	35 425	26.230	13 104	77 075	22 321
Failure to Pay	64 466	2 800	32 060	1 538	32.406	1 061
Bad Check	728	11	69	2	659	9
Fraud	-		-		-	
Negligence	32	9	-		32	9
Miscellaneous	17 447	24 340	6 666	7 155	10.781	17 185
Totals	**185.978**	**62.383**	**65.025**	**21.798**	**120.953**	**40.584**
Total All Civil Penalties	**19,593,785**	**2,112,450**	**2,028,717**	**550,581**	**17,565,048**	**1,552,860**

Notes: Amounts may not add due to rounding With the exception of estimated tax penalties can apply to any tax year Abatements can apply to any tax year

Less than $500

Includes Taxpayer Identification Number failure to report tips miscellaneous

[2] Includes Forms 1120 990C and 990T

[3] Includes Forms 940 941 94 943 and CT-1

[4] Includes negligence and estimated tax

[5] Includes Forms 1041A 5227 990PF 4720 990 4638 2290 11 11B 11C 720 and 730

[6] Includes negligence, miscellaneous and estimated tax

[7] Penalties are from processing of individual returns only and do not reflect other penalties assessable under the Tax Reform Act of 1976 Code sections 6694 and 6695

[8] Includes Forms 1041 1065 and individual retirement account file

Fiscal Year 1980

Table 14.–Civil penalties assessed and abated
(Dollars in thousands)

	Assessments		Abatements		Net Penalties	
	Number	Amount	Number	Amount	Number	Amount
Individual						
Delinquency	1,215,793	290,753	151,793	65,632	1,064,000	225,122
Estimated tax	5,259,988	638,444	239,953	54,424	5,020,035	584,020
Failure to pay	5,434,185	188,306	644,974	22,204	4,789,211	166,102
Bad check	157,800	1,480	5,453	223	152,347	1,257
Fraud	9,355	44,479	333	7,748	9,022	36,731
Negligence	122,078	15,928	2,252	1,064	119,826	14,864
Other [1]	9,643	855	470	54	9,173	801
Totals	12,208,842	1,180,245	1,045,228	151,349	11,163,614	1,028,897
Corporation [2]						
Delinquency	143,478	188,666	28,766	162,038	114,712	26,628
Estimated tax	321,548	160,406	45,197	58,069	276,351	102,337
Failure to pay	249,574	77,613	68,054	60,234	181,520	17,379
Bad check	2,763	65	135	24	2,628	41
Fraud	532	7,591	42	909	490	6,682
Negligence	3,847	5,198	92	365	3,755	4,834
Miscellaneous	65	70	8	7	57	63
Totals	721,807	439,609	142,294	281,646	579,513	157,963
Employment [3]						
Delinquency	2,304,041	395,551	182,367	76,933	2,121,674	318,618
Miscellaneous	663	268	230	83	433	185
Failure to pay	3,019,900	135,306	507,354	39,956	2,512,546	95,350
Federal tax deposits	2,772,368	507,717	323,218	148,251	2,449,150	359,466
Bad check	130,372	2,961	2,143	943	128,229	2,019
Fraud	1,438	2,218	53	33	1,385	2,184
Negligence	171	34	37	26	134	8
Totals	8,228,953	1,044,054	1,015,402	266,224	7,213,551	777,830
Excise [4]						
Delinquency	320,109	20,808	23,945	6,068	296,164	14,741
Daily delinquency	13,251	26,383	10,674	23,499	2,577	2,883
Failure to pay	238,072	21,513	63,199	7,734	174,873	13,779
Federal tax deposits	41,162	11,080	4,625	7,366	36,537	3,715
Bad check	3,380	22	96	1	3,284	21
Fraud	834	2,375	31	105	803	2,270
Other [5]	128	59	25	51	103	8
Totals	616,936	82,241	102,595	44,824	514,341	37,417
Estate and Gift						
Delinquency	16,174	49,943	5,419	36,831	10,755	13,111
Miscellaneous	6	10	1	1	5	8
Failure to pay	28,449	27,425	17,232	20,970	11,217	6,456
Bad check	434	102	85	80	349	22
Fraud	19	1,840	4	25	15	1,815
Negligence	32	22	3	2	29	20
Totals	45,114	79,142	22,744	57,910	22,370	21,231
Tax Return Preparers' Penalty [6]						
Failure to sign and failure to provide tax identification numbers	6,274	630	9,939	1,793	-3,665	-1,163
All Other [7]						
Delinquency	171,420	92,883	87,187	61,485	84,233	31,398
Failure to pay	61,700	3,172	24,260	1,757	37,440	1,415
Bad check	1,381	12	79	5	1,302	6
Negligence	56	8	1	*	55	8
Miscellaneous	34,558	55,178	22,926	36,432	11,632	18,746
Totals	269,115	151,253	134,453	99,679	134,662	51,574
Total All Civil Penalties	22,097,041	2,977,173	2,472,655	903,424	19,624,386	2,073,749

Note: Amounts may not add, due to rounding. With the exception of estimated tax, penalties can apply to any tax year. Abatements can apply to any tax year.

* Less than $500.

[1] Includes taxpayer identification number, failure to report tips, miscellaneous.

[2] Includes Forms 1120, 990C and 990T.

[3] Includes Forms 940, 941, 942, 943 and CT-1

[4] Includes Forms 1041A, 5227, 990PF, 4720, 990, 4638, 2290, 11, 11B, 11C, 720 and 730.

[5] Includes negligence and miscellaneous.

[6] Penalties are from processing of individual returns only and do not reflect other penalties assessable under the Tax Reform Act of 1976, *Code* sections 6694 and 6695.

[7] Includes Forms 1041, 1065 and individual retirement account file.

Table 14.—Civil penalties assessed and abated
(Dollars in thousands)

	Assessments		Abatements		Net penalties	
	Number	Amount	Number	Amount	Number	Amount
Individual						
Delinquency	1 369 742	346 381	186 332	83 417	1 183 410	262 964
Estimated tax	6 440 308	900 751	376 782	98 213	6 063 526	802 538
Failure to pay	6 066 815	223 751	720 088	28 604	5 346 727	195 147
Bad check	186 287	1 879	6 441	376	179 846	1 503
Fraud	9 898	56 847	357	4 078	9 541	52 769
Negligence	113 508	20 630	3 152	1 921	110 356	18 709
False withholding	12 254	6 131	1 700	850	10 554	5 281
Other [1]	9 350	1 030	862	109	8 488	921
Total	14,208,162	1,557,399	1,295,714	217,568	12,912,448	1,339,831
Corporation [2]						
Delinquency	147 194	208 307	28 626	155 034	118 568	53 273
Estimated tax	334 358	198 726	43 570	70 240	290 788	128 486
Failure to pay	253 208	298 156	75 550	72 532	177 658	225 624
Bad check	3 059	135	132	112	2 927	23
Fraud	499	8 118	59	4 920	440	3 197
Negligence	3 640	7 184	104	869	3 536	6 315
Miscellaneous	170	371	8	432	162	-61
Total	742,128	720,997	148,049	304,139	594,079	416,858
Employment [3]						
Delinquency	2 279 560	471 721	208 278	114 213	2 071 282	357 508
Miscellaneous	927	412	157	83	770	330
Failure to pay	3 416 766	169 852	668 542	62 748	2 748 224	107 104
Federal tax deposits	4 648 590	1 838 644	673 610	819 704	3 974 980	1 018 939
Bad check	139 820	2 659	2 160	102	137 660	2 558
Fraud	940	2 339	54	122	886	2 217
Negligence	126	24	14	2	112	23
Total	10,486,729	2,485,651	1,552,815	996,973	8,933,914	1,488,678
Excise [4]						
Delinquency	261 810	24 626	23 048	9 783	238 762	14 843
Daily delinquency	17 023	36 604	12 534	29 492	4 489	7 112
Failure to pay	227 279	17 255	63 849	22 608	163 430	-5 353
Federal tax deposits	33 887	14 336	5 091	8 704	28 796	5 632
Bad check	3 241	81	107	21	3 134	59
Fraud	839	9 287	30	136	809	9 151
Other [5]	109	14	12	2	97	11
Total	544,188	102,202	104,671	70,747	439,517	31,455
Estate and Gift						
Delinquency	14 084	43 478	4 785	29 785	9 299	13 694
Miscellaneous	16	11	7	8	9	3
Failure to pay	30 441	30 318	20 637	22 717	9 804	7 601
Bad check	540	123	89	66	451	57
Fraud	18	415	4	516	14	-101
Negligence	57	67	4	2	53	65
Total	45,156	74,412	25,526	53,094	19,630	21,318
All Other [6]						
Delinquency	175 222	108 954	96 591	81 504	78 631	27 450
Failure to pay	79 141	4 447	31 275	2 280	47 866	2 167
Bad check	1 488	25	98	5	1 390	20
Negligence	51	27	13	14	38	13
Miscellaneous	32	11	20 552	43 427	-20 520	-43 416
Total	255,934	113,464	148,529	127,230	107,405	-13,766
Total, all civil penalties	26,282,297	5,054,125	3,275,304	1,769,752	23,006,993	3,284,373

Note: Amounts may not add due to rounding. With the exception of estimated tax, penalties can apply to any tax year. Abatements can apply to any tax year.

[1] Includes taxpayer identification number, failure to report tips and miscellaneous.

[2] Includes Forms 1120, 990C and 990T.

[3] Includes Forms 940, 941, 942, 943 and CT-1.

[4] Includes Forms 1041A, 5227, 990PF, 4720, 990, 4638, 2290, 11, 11B, 11C, 720 and 730.

[5] Includes negligence and miscellaneous.

[6] Includes Forms 1041, 1065 and individual retirement account file.

Table 14.—Civil penalties assessed and abated
(Dollars in thousands)

	Assessments		Abatements		Net penalties	
	Number	Amount	Number	Amount	Number	Amount
Individual						
Delinquency	1,427,316	381,219	176,509	83,800	1,250,807	297,419
Estimated tax	4,953,142	909,377	365,558	170,487	4,587,584	738,890
Failure to pay	6,055,032	249,384	788,945	32,810	5,266,087	216,574
Bad check	191,415	1,964	6,518	376	184,897	1,588
Fraud	10,095	87,980	435	5,468	9,660	82,512
Negligence	113,630	26,210	3,783	1,733	109,847	24,478
False withholding	88,125	44,096	12,932	6,466	75,193	37,630
Other [1]	10,172	2,848	7,712	3,768	2,460	-920
Total	12,648,927	1,703,079	1,362,360	304,907	11,286,567	1,398,172
Corporation [2]						
Delinquency	138,180	173,758	27,937	150,519	110,243	23,239
Estimated tax	332,139	222,530	46,907	93,133	285,232	129,397
Failure to pay	248,790	77,833	77,847	264,825	170,943	-186,992
Bad check	3,077	3,734	114	6	2,963	3,728
Fraud	498	24,955	30	960	468	23,995
Negligence	3,531	7,724	92	2,038	3,439	5,686
Miscellaneous	297	77	4	56	293	21
Total	726,512	510,610	152,931	511,536	573,581	-926
Employment [3]						
Delinquency	2,251,353	476,413	252,509	131,870	1,998,844	344,543
Miscellaneous	3,820	2,400	754	614	3,066	1,786
Failure to pay	3,800,842	175,411	876,995	62,963	2,923,847	112,447
Federal tax deposits	4,453,548	1,425,165	879,372	956,020	3,574,176	469,146
Bad check	137,780	2,431	2,046	112	135,734	2,320
Fraud	940	1,833	54	168	886	1,665
Negligence	156	20	2	*	154	20
Total	10,848,439	2,083,673	2,011,732	1,151,747	8,836,707	931,926
Excise [4]						
Delinquency	334,222	25,605	25,941	10,535	308,281	15,069
Daily delinquency	14,833	32,488	13,161	32,109	1,672	378
Failure to pay	323,573	13,132	103,412	9,983	220,161	3,149
Federal tax deposits	35,188	15,199	6,427	8,800	28,761	6,399
Bad check	3,339	34	94	1	3,245	32
Fraud	1,333	1,601	21	74	1,312	1,528
Other [5]	137	4,685	6	2	131	4,683
Total	712,625	92,744	149,062	61,505	563,563	31,239
Estate and Gift						
Delinquency	11,690	40,887	3,999	31,719	7,691	9,168
Miscellaneous	17	49	8	33	9	16
Failure to pay	21,725	22,473	14,393	18,121	7,332	4,353
Bad check	454	70	80	57	374	12
Fraud	16	2,341	4	31	12	2,310
Negligence	22	60	3	*	19	60
Total	33,924	65,880	18,487	49,962	15,437	15,918
All Other [6]						
Delinquency	164,593	102,916	86,757	80,004	77,836	22,912
Failure to pay	87,870	5,412	41,209	3,189	46,661	2,223
Bad check	1,685	21	92	13	1,593	8
Fraud	3	5	–	–	3	5
Negligence	33	38	10	7	23	31
Miscellaneous	7,548	16,622	9,191	18,607	-1,643	-1,985
Total	261,732	125,015	137,259	101,821	124,473	23,195
Total, all civil penalties	25,232,159	4,581,001	3,831,831	2,181,477	21,400,328	2,399,523

Note: Totals may not add due to rounding. With the exception of estimated tax, penalties can apply to any tax year. Abatements can apply to any tax year.

[1] Includes taxpayer identification number, failure to report tips and miscellaneous.

[2] Includes Forms 1120, 990C and 990T.

[3] Includes Forms 940, 941, 942, 943 and CT-1.

[4] Includes Forms 1041A, 5227, 990PF, 4720, 990, 4638, 2290, 11, 11B, 11C, 720 and 730.

[5] Includes negligence and miscellaneous.

[6] Includes Forms 1041, 1065 and individual retirement account file.

* Less than $500.

Table 14.—Civil penalties assessed and abated

(Dollars in thousands)

	Assessments		Abatements		Net penalties	
	Number	Amount	Number	Amount	Number	Amount
Individual						
Delinquency	1,458,022	447,100	163,688	82,018	1,294,334	365,082
Estimated tax	4,652,161	788,848	368,432	202,502	4,283,729	586,346
Failure to pay	5,854,601	256,909	760,149	34,014	5,094,452	222,895
Bad check	183,138	1,980	6,130	346	177,008	1,634
Fraud	11,568	95,358	416	5,801	11,152	89,557
Negligence	128,956	62,843	5,180	3,552	123,776	59,291
False withholding	105,530	52,627	14,324	7,162	91,206	45,465
Other[1]	14,371	5,339	11,033	5,634	3,338	(295)
Total	12,408,348	1,711,304	1,329,322	341,029	11,079,026	1,369,175
Corporation[2]						
Delinquency	130,839	140,020	27,689	108,918	103,150	31,102
Estimated tax	315,877	303,262	48,644	166,253	267,233	137,009
Failure to pay	281,989	82,100	99,876	56,223	182,113	25,877
Bad check	2,759	59	119	3,686	2,640	(3,627)
Fraud	500	36,178	33	974	467	35,204
Negligence	3,034	8,152	98	562	2,936	7,590
Miscellaneous	339	367	12	14	327	353
Total	735,337	570,138	176,471	336,630	558,866	233,508
Employment[3]						
Delinquency	2,486,469	584,840	292,948	151,485	2,193,521	433,355
Miscellaneous	2,748	1,729	966	750	1,782	979
Failure to pay	4,256,585	215,801	1,157,124	74,047	3,099,461	141,754
Federal tax deposits	5,169,096	1,622,536	981,943	800,604	4,187,153	821,932
Bad check	131,010	3,889	1,973	140	129,037	3,749
Fraud	705	1,499	57	196	648	1,303
Other	165	24	8	21	157	3
Total	12,046,778	2,430,318	2,435,019	1,027,243	9,611,759	1,403,075
Excise[4]						
Delinquency	285,067	30,625	36,021	12,951	249,046	17,674
Daily delinquency	21,471	47,129	11,010	26,244	10,461	20,885
Failure to pay	267,057	15,233	95,772	9,026	171,285	6,207
Federal tax deposits	51,868	36,938	10,246	19,869	41,622	17,069
Bad check	2,817	30	100	2	2,717	28
Fraud	889	2,718	136	128	753	2,590
Other[5]	136	38	13	12	123	26
Total	629,305	132,711	153,298	68,232	476,007	64,479
Estate and Gift						
Delinquency	9,794	44,475	3,110	30,714	6,684	13,761
Miscellaneous	11	19	2	6	9	13
Failure to pay	18,228	25,046	12,043	18,779	6,185	6,267
Bad check	315	77	50	52	265	25
Fraud	18	204	1	23	17	181
Negligence	18	50	11	7	7	43
Total	28,384	69,871	15,217	49,581	13,167	20,290
All Other[6]						
Delinquency	187,970	114,731	89,441	76,906	98,529	37,825
Failure to pay	99,691	6,852	44,268	4,340	55,423	2,512
Bad check	1,760	26	93	10	1,667	16
Fraud	2	1	—	—	2	1
Negligence	50	161	4	7	46	154
Miscellaneous	8,399	13,632	6,466	14,846	1,933	(1,214)
Total	297,872	135,403	140,272	96,109	157,600	39,294
Total, all civil penalties	26,146,024	5,049,845	4,248,599	1,929,024	21,898,425	3,120,821

Note: Totals may not add due to rounding. With the exception of estimated tax, penalties can apply to any tax year. Abatements can apply to any tax year.

[1] Includes taxpayer identification number, failure to report tips and miscellaneous.

[2] Includes Forms 1120, 990C and 990T.

[3] Includes Forms 940, 941, 942, 943 and CT-1.

[4] Includes Forms 1041A, 5227, 990PF, 4720, 990, 4638, 2290, 11, 11C, 720 and 730.

[5] Includes negligence and miscellaneous.

[6] Includes Forms 1041, 1065 and individual retirement account file.

Fiscal Year 1984

Table 14.—Civil penalties assessed and abated
(dollars in thousands)

	Assessments		Abatements		Net penalties	
	Number	Amount	Number	Amount	Number	Amount
Individual						
Delinquency	1,532,358	523,097	185,453	123,506	1,346,905	399,591
Estimated tax	3,066,233	680,147	329,439	239,748	2,736,794	440,399
Failure to pay	5,965,987	286,502	716,067	34,675	5,249,920	251,827
Bad check	189,343	2,099	4,952	291	184,391	1,808
Fraud	10,983	109,512	536	22,919	10,447	86,593
Negligence	179,943	137,989	7,301	7,634	172,642	130,355
False withholding	21,656	10,826	3,941	1,971	17,715	8,855
Other[1]	25,223	15,964	14,160	7,470	11,063	8,494
Total	10,991,726	1,766,136	1,261,849	438,214	9,729,877	1,327,922
Corporation[2]						
Delinquency	134,636	181,386	26,049	103,666	108,587	77,720
Estimated tax	315,653	450,073	45,080	334,998	270,573	115,075
Failure to pay	338,060	421,144	131,056	369,618	207,004	51,526
Bad check	2,628	81	93	12	2,535	69
Fraud	586	15,979	46	2,408	540	13,571
Negligence	2,867	16,781	87	2,327	2,780	14,454
Miscellaneous	7,731	33,638	225	1,814	7,506	31,824
Total	802,161	1,119,082	202,636	814,843	599,525	304,239
Employment[3]						
Delinquency	2,393,449	648,154	342,173	172,603	2,051,276	475,551
Miscellaneous	1,896	1,014	572	470	1,324	544
Failure to pay	4,408,382	302,865	1,490,317	128,087	2,918,065	174,778
Federal tax deposits	2,445,454	1,367,076	936,576	793,885	1,508,878	573,191
Bad check	114,116	2,419	1,672	192	112,444	2,227
Fraud	627	1,719	30	53	597	1,666
Other	127	9	—	—	127	9
Total	9,364,051	2,323,256	2,771,340	1,095,290	6,592,711	1,227,966
Excise[4]						
Delinquency	218,151	38,621	32,558	15,708	185,593	22,913
Daily delinquency	23,956	38,591	23,651	50,106	305	(11,515)
Failure to pay	242,641	28,183	74,133	17,923	168,508	10,260
Federal tax deposits	33,534	33,661	9,141	14,362	24,393	19,299
Bad check	2,403	32	61	2	2,342	30
Fraud	1,055	3,833	72	91	983	3,742
Other[5]	163	1,677	5	4	158	1,673
Total	521,903	144,598	139,621	98,196	382,282	46,402
Estate and Gift						
Delinquency	8,841	66,638	3,114	41,871	5,727	24,767
Miscellaneous	41	48	10	3	31	45
Failure to pay	17,159	38,691	9,587	23,212	7,572	15,479
Bad check	252	59	42	32	210	27
Fraud	8	207	1	*	7	207
Negligence	13	73	3	9	10	64
Total	26,314	105,716	12,757	65,127	13,557	40,589
All other[6]						
Delinquency	196,171	147,663	101,699	102,215	94,472	45,448
Failure to pay	86,736	5,862	32,769	3,736	53,967	2,126
Bad check	1,635	19	77	4	1,558	15
Fraud	8	43	—	—	8	43
Negligence	45	58	10	144	35	(86)
Miscellaneous	7,292	15,234	5,443	11,681	1,849	3,553
Total	291,887	168,879	139,998	117,780	151,889	51,099
Non-return[7]	37,025	49,962	964	2,130	36,061	47,832
Total, all civil penalties	22,035,067	5,677,629	4,529,165	2,631,580	17,505,902	3,046,049

Note: With the exception of estimated tax, penalties can apply to any tax year. Abatements can apply to any tax year.

[1] Includes taxpayer identification number, failure to report tips and miscellaneous.

[2] Includes Forms 1120, 990C and 990T.

[3] Includes Forms 940, 941, 942, 943 and CT-1.

[4] Includes Forms 1041A, 5227, 990PF, 4720, 990, 4638, 2290, 11, 11C, 720 and 730.

[5] Includes negligence and miscellaneous.

[6] Includes Forms 1041, 1065 and individual retirement account file.

[7] Includes penalties assessable under the Tax Equity and Fiscal Responsibility Act of 1982.

* Less than $500.

Table 14.—Civil penalties assessed and abated
(dollars in thousands)

[illegible]	Assessments		Abatements		Net penalties	
	Number	Amount	Number	Amount	Number	Amount
Individual						
Delinquency	1,578,599	552,643	226,460	146,640	1,352,139	406,003
Estimated tax	2,720,142	985,555	198,557	594,098	2,521,585	391,457
Failure to pay	6,714,055	365,937	901,937	55,525	5,812,118	310,412
Bad check	230,982	2,753	6,397	407	224,585	2,346
Fraud	11,841	151,270	786	23,210	11,055	128,060
Negligence	229,461	245,807	18,398	46,565	211,063	199,242
False withholding	1,076	569	114	57	962	512
Other [1]	133,964	177,756	24,818	23,430	109,146	154,326
Total	11,620,122	2,482,290	1,377,467	889,932	10,242,655	1,592,358
Corporation [2]						
Delinquency	163,909	598,450	56,778	423,284	107,131	175,166
Estimated tax	336,087	331,448	63,207	179,500	272,880	151,948
Failure to pay	431,895	383,899	183,154	273,308	248,741	110,591
Bad check	3,627	92	119	31	3,508	61
Fraud	603	26,268	23	3,589	580	22,679
Negligence	3,578	28,898	205	2,376	3,373	26,522
Miscellaneous	13,815	138,037	4,943	37,934	8,872	100,103
Total	953,514	1,507,092	308,429	920,022	645,085	587,070
Employment [3]						
Delinquency	2,614,376	763,092	635,833	260,691	1,978,543	502,401
Miscellaneous	5,222	5,222	1,244	1,737	3,978	3,485
Failure to pay	5,181,985	376,796	1,223,753	186,043	3,958,232	190,753
Federal tax deposits	984,776	620,180	356,230	444,775	628,546	175,405
Bad check	130,433	2,948	1,876	1,455	128,557	1,493
Fraud	557	1,850	49	47	508	1,803
Other	163	47	1	*	162	47
Total	8,917,512	1,770,135	2,218,986	894,748	6,698,526	875,387
Excise [4]						
Delinquency	407,481	110,008	76,529	83,380	330,952	26,628
Daily delinquency	40,061	57,481	27,224	41,808	12,837	15,673
Failure to pay	440,264	29,688	94,207	22,388	346,057	7,300
Federal tax deposits	26,189	45,731	7,910	30,934	18,279	14,797
Bad check	4,946	86	109	12	4,837	74
Fraud	1,594	5,637	221	272	1,373	5,365
Other [5]	288	882	31	74	257	808
Total	920,823	249,513	206,231	178,868	714,592	70,645
Estate and Gift						
Delinquency	9,225	53,179	4,463	52,925	4,762	254
Miscellaneous	67	254	11	8	56	246
Failure to pay	16,967	36,664	13,185	35,167	3,782	1,497
Bad check	339	66	57	42	282	24
Fraud	30	870	8	194	22	676
Negligence	45	137	1	9	44	128
Total	26,673	91,170	17,725	88,345	8,948	2,825
All Other [6]						
Delinquency	237,460	361,492	133,205	196,872	104,255	164,620
Failure to pay	120,778	13,118	42,648	8,150	78,130	4,968
Bad check	2,128	38	118	13	2,010	25
Fraud	2	10	—	—	2	10
Negligence	98	488	24	144	74	344
Miscellaneous	8,336	185,341	6,875	185,617	1,461	(276)
Total	368,802	560,487	182,870	390,796	185,932	169,691
Non-return [7]	106,111	267,578	20,271	50,370	85,840	217,208
Total, all civil penalties	22,913,557	6,928,265	4,331,979	3,413,081	18,581,578	3,515,184

Note: With the exception of estimated tax, penalties can apply to any tax year. Abatements can apply to any tax year.

[1] Includes taxpayer identification number, failure to report tips and miscellaneous.

[2] Includes Forms 1120, 990C and 990T.

[3] Includes Forms 940, 941, 942, 943 and CT-1.

[4] Includes Forms 1041A, 5227, 990PF, 990, 4720, 4638, 2290, 11, 11C, 720 and 730.

[5] Includes negligence and miscellaneous.

[6] Includes Forms 1041, 1065 and individual retirement account file.

[7] Includes penalties assessable under the Tax Equity and Fiscal Responsibility Act of 1982 and the Tax Reform Act of 1984.

* Less than $500.

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14 Civil penalties assessed and abated (dollars in thousands)	Assessments Number	Amount	Abatements Number	Amount	Net penalties Number	Amount
Individual............						
Delinquency..........	1,704,288	646,469	229,913	140,467	1,531,373	506,002
Estimated tax........	2,930,267	385,762	400,330	70,901	2,787,936	432,762
Failure to pay.......	7,143,444	406,467	912,473	34,880	6,230,191	371,737
Bad check............	234,086	3,772	8,638	1,179	225,448	2,593
Fraud................	11,595	171,670	764	26,436	10,831	144,830
Negligence...........	933,432	305,600	28,860	45,133	904,772	260,471
False withholding....	16,270	1,857	19	10	16,251	1,847
Other 1	80,043	140,083	13,371	82,806	66,672	57,277
Total............	13,137,083	2,217,368	1,383,369	421,292	11,834,476	1,796,326
Corporation 2						
Delinquency..........	156,786	499,775	48,554	493,914	108,232	5,861
Estimated tax........	304,467	439,160	69,825	349,100	234,627	90,039
Failure to pay.......	420,095	251,601	149,663	272,570	270,028	(20,969)
Bad check............	3,427	110	267	57	3,160	53
Fraud................	337	34,644	32	19,277	305	15,367
Negligence...........	3,196	27,149	206	7,518	2,990	19,631
Miscellaneous........	113,950	282,410	25,965	137,780	87,993	144,626
Total............	1,082,090	1,334,893	270,307	1,280,217	720,333	254,628
Employment 3						
Delinquency..........	2,376,679	880,263	379,232	320,313	2,197,447	559,950
Miscellaneous........	6,087	5,680	2,482	3,512	3,725	2,172
Failure to pay.......	5,035,460	374,999	900,027	162,096	4,073,383	212,093
Federal tax deposits.	3,477,077	2,447,105	519,725	790,192	2,957,322	1,656,911
Bad check............	122,077	2,903	3,067	313	118,900	2,590
Fraud................	886	2,385	73	172	813	2,213
Other................	192	360	20	95	172	265
Total............	11,220,678	3,693,047	1,886,436	1,277,091	9,332,242	2,416,356
Excise 4						
Delinquency..........	283,787	52,396	38,386	24,964	245,401	27,429
Daily delinquency....	44,837	71,089	32,980	57,969	11,857	13,120
Failure to pay.......	332,123	22,270	74,127	16,006	257,996	6,263
Federal tax deposits.	45,300	90,098	8,904	32,296	36,404	57,993
Bad check............	3,121	56	232	20	4,089	36
Fraud................	1,101	3,562	204	340	937	3,222
Other 5	425	1,939	97	267	328	1,672
Total............	733,622	263,922	155,010	151,813	578,612	112,109
Estate and Gift						
Delinquency..........	7,640	45,737	3,370	44,126	4,270	1,611
Miscellaneous........	196	716	26	160	170	556
Failure to pay.......	11,396	27,040	7,226	25,332	4,170	1,696
Bad check............	289	97	66	62	223	35
Fraud................	14	1,383			14	1,383
Negligence...........	15	79	3	36	12	43
Total............	19,500	75,253	10,691	69,736	8,809	5,517
All Other 6						
Delinquency..........	230,971	387,696	117,130	426,393	113,841	(38,697)
Failure to pay.......	115,742	11,327	42,970	7,852	72,772	3,475
Bad check............	2,043	34	104	16	2,239	18
Fraud................	1	0	-	-	1	0
Negligence...........	137	642	19	132	118	510
Miscellaneous........	8,805	12,726	6,348	16,081	2,457	(3,355)
Total............	358,099	392,643	166,631	450,474	191,468	(57,879)
Non-return 7	478,287	6,091,110	71,630	423,462	406,657	5,667,648
Total, all civil penalties	26,968,271	14,209,389	3,868,314	4,234,634	23,099,957	9,974,756

Notes: With the exception of estimated tax, assessments and abatements can apply to [illegible] year.
Negative net amounts reflect abatements of assessments reported in a prior fiscal year.

1 Includes taxpayer identification number, failure to report tips and miscellaneous.

2 Includes Forms 1120, 990C and 990T.

3 Includes Forms 940,941,942,943 and CT-1.

4 Includes Forms 1041A,5227,990PF,990,4720,4638,2290,11,11C,720 and 730.

5 Includes negligence and miscellaneous.

6 Includes Forms 1041,1065 and individual retirement account file.

7 Includes penalties assessable under the Tax Equity and Fiscal Responsibility Act of 1982 and the Tax Reform Act of 1984. Also contains amounts under IRC section 6672 but not reported in prior years because they were manually assessed. The amounts can now be reported because they were transferred to the computerized master file this year. Actual non-return penalty amounts for FY 1987 were 266,636 assessments for $1,383,363,000 and 70,846 abatements for $612,372,000.

FISCAL YEAR 1987 (draft)

TABLE OF PENALTY SECTIONS

KEYED TO TABLE 14

COMMISSIONER'S ANNUAL REPORT

Title per Report	Internal Revenue Code Section
Individual	
Delinquency	6651(a)
Estimated Tax	6654
Failure to Pay	6651(b)
Bad Check	6657
Fraud	6653(b)
Negligence	6653(a), 6621(c) 6653(f), 6653(g), 6661 and 6659
False Withholding	6682
Other	All other miscellaneous penalties applicable to individuals.
Corporations	
Delinquency	6651(a)
Estimated Tax	6655
Failure to Pay	6651(b)
Federal Tax Deposits	6656(a)
Bad Check	6657
Fraud	6653(b)
Negligence	6653(a), etc.
Other	Includes daily delinquency and miscellaneous penalties.
Employment	
Delinquency	6651(a)
Miscellaneous	All other penalties applicable to payroll taxes
Failure to Pay	6651(b)
Federal Tax Deposits	6656(a)
Bad Check	6657
Fraud	6653(b)
Other	Includes estimated tax (6654 or 6655), daily delinquency, and negligence (6653(a).
Excise	
Delinquency	6651(a)
Daily Delinquency	
Failure to Pay	6651(b)
Federal Tax Deposits	6656(a)
Bad Check	6657
Fraud	6653(b)
Other	Includes estimated tax, miscellaneous and negligence

Title per Report	Internal Revenue Code Section
Estate and Gift	
Delinquency	6651(a)
Miscellaneous	miscellaneous penalties
Failure to Pay	6651(b)
Bad Check	6657
Fraud	6653(b)
Negligence	6653(a)
Tax Return Preparer's Penalties (Statistics are provided in 1978 through 1981 for failure to sign returns and failure to provide tax identification numbers. This data is not separately provided after 1981.)	
All Other	Includes miscellaneous returns such as 1041 (fiduciary income tax), 1065 (partnership), et al.
Delinquency	6651(a)
Failure to Pay	6651(b)
Bad Check	6657
Fraud	6653(b)
Negligence	6653(a)
Other	includes several miscellaneous sections.

SECTION 6651(a) FAILURE TO FILE TIMELY

Fiscal Year	Type	Assessed Volume	Abated Volume	Abatement Rate	Assessed Dollars	Abated Dollars	Abatement Rate
83	Individual	1,427,318	176,509	12.4%	381,219	83,800	22.0%
84		1,458,022	163,608	11.2%	447,100	92,018	20.6%
85		1,532,358	185,453	12.1%	523,097	123,505	23.6%
86		1,578,599	226,460	14.3%	552,643	146,640	26.5%
87		1,744,208	192,913	11.1%	646,519	141,617	21.9%
83	Corporate	138,180	27,937	20.2%	173,758	150,519	86.6%
84		130,039	27,609	21.2%	140,020	108,918	77.8%
85		134,638	26,049	19.3%	181,306	103,666	57.2%
86		163,909	56,770	34.6%	598,450	423,204	70.7%
87		156,786	48,564	31.0%	499,775	493,914	98.8%
83	Employment	2,251,353	252,509	11.2%	476,413	131,870	27.7%
84		2,486,469	292,940	11.8%	584,040	151,485	25.9%
85		2,393,449	342,173	14.3%	648,154	172,603	26.6%
86		2,614,376	635,833	24.3%	763,092	260,691	34.2%
87		2,576,679	379,232	14.7%	860,263	320,313	37.2%

Section 6651(b) FAILURE TO PAY

Fiscal Year	Type	Assessed Volume	Abated Volume	Abatement Rate	Assessed Dollars	Abated Dollars	Abatement Rate %
83	Individual	6,055,032	788,945	13.0%	249,384	32,810	13.2
84		5,854,601	760,149	13.0%	256,989	34,014	13.2
85		5,965,987	716,067	12.0%	286,502	34,675	12.1
86		6,714,055	901,937	13.4%	365,937	55,525	15.2
87		7,163,664	812,473	12.7%	446,617	54,880	12.3
83	Corporate	248,790	77,847	31.3%	77,033	264,825	340.2
84		281,989	99,876	35.4%	82,100	56,223	68.5
85		338,060	131,056	38.8%	421,144	369,618	87.8
86		431,895	183,154	42.4%	383,899	273,308	71.2
87		420,491	149,663	35.6%	251,601	272,570	108.3
83	Employment	3,800,842	875,995	23.1%	175,411	62,963	35.9
84		4,256,505	1,157,124	27.2%	215,801	74,047	34.3
85		4,408,302	1,490,317	33.8%	302,865	128,007	42.3
86		5,101,985	1,223,753	23.6%	376,796	186,043	49.4
87		5,055,410	981,827	19.4%	374,949	162,894	43.4

SECTION 6653(a) NEGLIGENCE

Fiscal Year	Type	Assessed Volume	Abated Volume	Abatement Rate	Assessed Dollars	Abated Dollars	Abatement Rate
83	Individual	113,630	3,783	3.3%	26,210	1,733	6.6%
84		128,956	5,180	4.0%	62,843	3,552	5.7%
85		179,943	7,301	4.1%	137,989	7,634	5.5%
86		229,461	18,398	8.0%	245,807	46,565	18.9%
87		953,632	28,860	3.0%	303,604	43,133	14.2%
83	Corporate	3,531	92	2.6%	7,724	2,038	26.4%
84		3,034	98	3.2%	8,152	562	6.9%
85		2,867	87	3.0%	16,761	2,327	13.9%
86		3,578	205	5.7%	28,898	2,376	8.2%
87		3,194	201	6.3%	27,141	7,510	27.7%

SECTION 6653(b) FRAUD

Fiscal Year	Type	Assessed Volume	Abated Volume	Abatement Rate	Assessed Dollars	Abated Dollars	Abatement Rate
83	Individual	10,095	405	4.0%	87,980	5,468	6.2%
84		11,568	416	3.6%	95,358	5,801	6.1%
85		10,903	536	4.9%	109,512	22,919	20.9%
86		11,841	786	6.6%	151,270	23,210	15.3%
87		11,595	764	6.6%	171,474	26,636	15.5%
83	Corporate	498	30	6.0%	24,955	960	3.8%
84		500	33	6.6%	36,178	974	2.7%
85		586	46	7.8%	15,979	2,408	15.1%
86		603	23	3.8%	26,268	3,509	13.7%
87		537	32	6.0%	34,644	19,277	55.6%
83	Employment	940	54	5.7%	1,833	168	9.2%
84		705	57	8.1%	1,499	196	13.1%
85		1,055	72	6.8%	3,833	91	2.4%
86		557	49	8.8%	1,850	47	2.5%
87		1,141	204	17.9%	5,562	340	6.1%

SECTION 6654 ESTIMATED TAX PENALTY

Fiscal Year	Type	Assessed Volume	Abated Volume	Abatement Rate	Assessed Dollars	Abated Dollars	Abatement Rate %
83	Individual	4,953,142	365,558	7.4%	909,377	170,487	18
84		4,652,161	368,432	7.9%	788,848	202,502	25
85		3,066,233	329,439	10.7%	680,147	239,748	35
86		2,720,142	198,557	7.3%	985,555	594,098	60
87		2,934,267	146,331	5.0%	503,742	70,981	14

SECTION 6655 ESTIMATED TAX PENALTY

Fiscal Year	Type	Assessed Volume	Abated Volume	Abatement Rate	Assessed Dollars	Abated Dollars	Abatement Rate
83	Corporate	332,139	46,907	14.1%	222,530	93,133	41.9%
84		315,877	48,644	15.4%	303,262	166,253	54.8%
85		315,653	45,080	14.3%	450,073	334,998	74.4%
86		336,087	63,207	18.8%	331,448	179,500	54.2%
87		304,447	49,825	16.4%	439,160	349,101	79.5%

SECTION 6656(a) FEDERAL TAX DEPOSITS

Fiscal Year	Type	Assessed Volume	Abated Volume	Abatement Rate	Assessed Dollars	Abated Dollars	Abatement Rate
83	Employment	4,453,548	879,372	19.7%	1,425,165	956,020	67.1%
84		5,169,096	981,943	19.0%	1,622,536	800,604	49.3%
85		2,445,454	936,576	38.3%	1,367,076	793,865	58.1%
86		984,776	356,530	36.2%	620,180	444,775	71.7%
87		3,477,077	519,755	14.9%	2,447,103	790,192	32.3%

SECTION 6657 DISHONORED CHECK

Fiscal Year	Type	Assessed Volume	Abated Volume	Abatement Rate	Assessed Dollars	Abated Dollars	Abatement Rate
83	Individual	191,415	6,516	3.4%	1,964	376	19.1%
84		183,139	6,130	3.3%	1,980	346	17.5%
85		189,343	4,952	2.6%	2,099	291	13.9%
86		230,982	6,397	2.8%	2,753	407	14.8%
87		234,086	8,638	3.7%	3,772	1,179	31.3%
83	Corporate	3,077	114	3.7%	3,734	6	0.2%
84		2,759	119	4.3%	59	3,686	6247.5%
85		2,628	93	3.5%	81	12	14.8%
86		3,627	119	3.3%	92	31	33.7%
87		3,427	267	7.8%	110	57	51.8%
83	Employment	137,780	2,046	1.5%	2,431	112	4.6%
84		131,010	1,973	1.5%	3,889	140	3.6%
85		114,116	1,672	1.5%	2,419	192	7.9%
86		130,433	1,876	1.4%	2,948	1,455	49.4%
87		122,027	3,047	2.5%	2,903	313	10.8%
				--			ERR

SECTION 6682 FALSE WITHHOLDING

Fiscal Year	Type	Assessed Volume	Abated Volume	Abatement Rate	Assessed Dollars	Abated Dollars	Abatement Rate
83	Individual	88,125	12,932	14.7%	44,096	6,465	14.7%
84		105,530	14,324	13.6%	52,827	7,162	13.6%
85		21,656	3,941	18.2%	10,826	1,971	18.2%
86		1,076	569	52.9%	114	57	50.0%
87		16,270	1,857	11.4%	19	10	52.6%

TOTAL PENALTIES ALL TAXPAYERS

Fiscal Year	Type	Assessed Volume	Abated Volume	Abatement Rate	Assessed Dollars	Abated Dollars	Abatement Rate
83		25,232,159	3,831,831	15.2%	4,581,001	2,181,477	47.6%
84		26,146,024	4,249,599	16.3%	5,049,645	1,928,924	38.2%
85		22,035,067	4,529,165	20.6%	5,677,629	2,631,580	46.3%
86		22,913,557	4,331,979	18.9%	6,928,265	3,413,081	49.3%
87		26,968,271	3,868,314	14.3%	14,249,389	4,254,634	29.9%

This is the total from each of the table 14 reports for each fiscal period.

QUESTIONS FROM THE HOUSE WAYS AND MEANS SUBCOMMITTEE

2. The Subcommittee is interested in what effect multiple penalty assessments have on taxpayer morale and compliance. What penalty provisions are frequently combined with other penalties resulting in high cumulative total assessments? We are particularly interested in those combinations (coupled with interest) which could potentially exceed the underlying tax deficiency by 100%.

RESPONSE: The problem of stacking (also called "pyramiding") is one of concern to the the Internal Revenue Service, practitioners, and taxpayers as well. Regular interest is excluded from our discussion of stacked penalties because interest is not viewed as a penalty, but rather is a cost for the use of money.

When fraud is present, the combination of the section 6653(b)(1)(A) civil fraud penalty and the section 6653(b)(1)(B) penalty will exceed the tax deficiency in most cases; the section 6653(b)(1)(B) penalty is equal to 50 percent of the interest on the portion of the deficiency due to fraud. In addition, if the transaction was also tax-motivated, section 6621(c) provides that the rate of interest applied to the deficiency will be 120 percent of the statutory interest rate. Use of the higher rate will, of course, increase the section 6653(b)(1)(B) penalty and increase the likelihood that the combined penalties exceed the deficiency.

Where there is a tax shelter, the combination of sections 6659 (overvaluation), 6661 (substantial understatement), 6621(c) (tax-motivated transaction) and 6653(a) (negligence) generally will result in total penalties (including the interest based add-ons) in excess of the tax. The statute clearly provides for this result.

Attached is an example of a situation where the penalties and interest do exceed the tax due.

Example:

FACTS:

1987 Tax Rates - Single

5,304 + 35% over 27,000
14,754 + 38.5% over 54,000

Tax per return

Taxable income	50,000	per return			
	-27,000				
	23,000	X	35% =	8,050	
			+	5,304	
Tax per Return					$13,354

Tax as Corrected

Taxable income	90,000				
	-54,000				
	36,000	X	38.5% =	13,860	
			+	14,754	
Tax as Corrected					$28,614

Deficiency $15,260

Note that the alternative minimum tax was not considered in this example.

SECTION 6651(a)(1)

1. Late filing penalty
(no fraud present)

5% x 5 months = 25% x $28,614 = $ 7,153

2. Delinquency

IRC 6653(d)	Amount subject to deliquency penalty	$ 28,614
	Underpayment subject to fraud penalty	7,700
	Underpayment subject to Section 6651(a)(1)	$ 20,914
		x 25%
		$ 5,228

Section 6659

Deficiency						$15,260
Taxable Income per return					50,000	
Adjustment: Other than Overvalued Property					20,000	
					$70,000	
Tax =	$70,000					
	54,000					
	$16,000	x	38.5%	=	$ 6,160	
				+	14,754	
					20,914	
Tax Per return					$13,354	
						7,560
Underpayment subject to Section 6659						$ 7,700
Penalty =	$7,700	x	30%	=	$ 2,310	

Section 6661

Tax as Corrected	$28,614	
Tax per Return	13,354	
Substantial Understatement	$15,260	
Section 6661 Underpayment above	$15,260	
Section 6659 Underpayment	7,700	
Section 6661 penalty = 25% x	7,560	= $1,890

Assumption

No substantial authority and no adequate disclosure for any of the adjustments.

Negligence 6653(a)

5% of Underpayment*

1. Tax as Corrected $28,614 X 5% = $1,430.

   Penalty of $1,430 + 50% of interest on portion of underpayment attributable to negligence.

   *On late filed return the penalty is on entire tax not just on the underpayment.

2. Underpayment Not Attributable to Fraud = $20,914
   5%
   $ 1,045 plus 50% of interest on portion of underpayment due to negligence.

Fraud Section 6653(b)

75% of Portion of Underpayment Due to Fraud

Fraud-depreciation adjustment	$20,000		
Total underpayment			$28,614
Underpayment Not Attributable to Fraud - Taxable Income per return		50,000	
	+	5,000	
	+	15,000	
Taxable Income		$70,000	
Tax on $70,000	=	$20,914	
Underpayment Not Attributable to Fraud -			20,914
Underpayment Attributed to Fraud			$ 7,700

Penalty = 75% x $7,700 = $5,775.00 + 50% of interest on $7,700.

Situation 1 (Fraud Present)

Fraud Section 6653(b)	=	$ 5,775 + 50% of interest on $7,700.
Negligence Section 6653(a)	=	$ 1,045 + 50% of interest on underpayment due to negligence.
Delinquency Section 6651(a)(1)	=	$ 5,228
Substantial Understatement Section 6661	=	$ 1,890
Valuation Overstatement penalty Section 6659	.	$ 2,310
Penalties		$16,248 plus interest of 120% on Tax Motivated Transactions for tax year 1987 (No interest rates available for 1988)

Situation 2 (No Fraud Present)

Negligence Section 6653	$ 1,430 +	50% of interest on portion of attributable to negligence.
Valuation Overstatement Section 6659	$ 2,310	
Substantial Understatememt Section 6661	$ 1,890	
Deficiency Section Section 6651(a)(1) 5% for 5 months	$ 7,153	
Penalties	$12,783 +	120% interest on tax motivated transactions.

APPENDIX C

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

MAR 24 1988

Ms. Beth K. Vance
Staff Director
Subcommittee on Oversight
Ways and Means Committee
1105 Longworth House Office Building
Washington, D.C. 20515-6350

Dear Beth:

Enclosed are answers to question three that you submitted to us in a letter dated Febraury 19, 1988. If you have any questions, please call me on 566-6070 or Ken Nichols on 566-4067.

Sincerely yours,

Gayle G. Morin

Gayle G. Morin
Director
Legisaltive Affairs Division

QUESTIONS FROM THE HOUSE WAYS AND MEANS SUBCOMMITTEE

3. It is our understanding that approximately 90% of all penalties are computer generated and that roughly one half are ultimately abated. Please provide a detailed analysis of computer generated penalty assessments. The following items should be addressed:

To fully respond to this series of questions, we would like first to discuss the definition of "computer generated" as used in the question and some of the literature. What IRS means by "computer generated" is that the computation of the penalty and the preparation of the billing were performed within the computer's program based on information transcribed by a person from the return or from other sources such as deposit information.

For example penalties, such as the failure to pay estimated tax penalty, are computer generated based upon information from the return, such as tax liability and information in the data base, such as when estimated tax payments were made. Also in the data base is the amount of the previous year's tax, which permits the computer to calculate one of the four statutory exceptions to the estimated tax penalty before generating a penalty notice. If the taxpayer files a Form 2210 with the return, the additional information provided on that form is entered into the data base by the tax examiner and is taken into account in the computer's calculation of the penalty. If a penalty is warranted, the computer prepares the notice which advises the taxpayer of the amount of penalty that is due.

Throughout the assessment process there is a human involved in the entry of the data into the computer record, and therefore, an opportunity for the human to effect the assertion or non-assertion of the penalty. Additionally, there is opportunity for review of notices being sent to taxpayers. However, once the information is entered into the computer, verification that the penalty notice is correct is done on a sample basis only. Since the internal logic of the program is carefully tested before being put into use, the most common errors in penalty notices generated by the computer are human errors, including the failure to enter data correctly or completely. There are a number of controls to ensure quality of data transcription and account verification within the system designed to catch these errors, especially errors of a systemic nature, and error rates are carefully monitored. However, errors can and do occur which result in incorrect penalty notices. We capture data on taxpayer responses to notices in an effort to identify problems associated with the processing of tax returns or data entry.

It should be noted that any penalty which may be asserted within the scope of a computer program may also be asserted by a human examiner. Further, abatements may also be made by human intervention, or, in limited circumstances, by computer. An example of a situation where the computer programming results in an abatement of a penalty is the failure to file penalty in section 6651(a). The penalty, by statute, is a percentage of the amount of tax due. If the tax due were, say, $1000, and the return were filed five months late, the penalty would be $250. Suppose that two years later the taxpayer has a net operating loss which can properly be carried back to the penalty year, thereby reducing the tax for that year to $500. The tax being reduced, the computer will automatically (and properly) reduce the penalty to $125, based solely on the reduction in the amount of tax due, and that reduction would show up as an abatement.

A specific example of the procedures for processing the information and asserting an estimated tax penalty is attached.

a. What percentage of total penalty assessments are computer generated?

b. Which penalty assessments are computer generated? Please provide the Code section and description of the penalty, the number of assessments, and the dollar amounts?

RESPONSE: IRS separately tracks computer-assessed and manually-assessed penalties only for the failure-to-deposit (FTD) penalty. Manual assessments are coded differently from computer assessments, but the data is not accumulated routinely in any internal reports. We may, as part of the Commissioner's Penalty Study, develop some of the statistics on computer versus manual assessments. That information will be shared with the subcommittee when it is available.

Any penalty that can be computer generated can also be manually assessed, abated or adjusted. Generally, once a manual penalty transaction is applied to a tax account, the computer is restricted from further computations of that penalty. Subsequent modifications, if any, must be done manually.

The following is a list of penalty types that can be computer generated as well as manually assessed.

Internal Revenue Code Section	Description
6651(a)	Failure to File Timely
6654 & 6655	Estimated Tax Penalty
6651(b)	Failure to Pay
6656	Federal Tax Deposit
6652(c), (d) (e) (f) etc.	Daily Delinquency Penalties
6698	Failure to Provide Partnership Information or File a Partnership Return
6657	Bad Check Penalty
6676	Failure to Supply Taxpayer Identifying Number (TIN)

c. What is the average amount of a single computer generated assessment?

RESPONSE: Since the computer generated penalties are not captured separately, we are unable to provide the information requested. However, the average dollar amount of a penalty does not seem to be relevant to the efficacy of the current penalty structure, given the wide differences in the purpose and method of computation of the various penalties which can be computer assessed. It may be appropriate to consider the average dollar amount of penalty assessments for each of the major types of penalties asserted (which is shown below). However, there are wide variations between the amounts of penalty assertions within each penalty category and among the different types of penalties. For example, the section 6698 penalty is based on the number of partners and is a flat dollar amount per partner for each month the return is late, with a cap, while the section 6651(a) penalty is a percentage of tax due adjusted by the length of the delinquency.

AVERAGE DOLLAR PENALTY
1987 Fiscal Year

Penalty	Average Assessment	Average Abatement
INDIVIDUALS		
Failure to file	$ 371	$ 734
Failure to Pay	62	60
Estimated Tax	172	485
Bad Check	10	58
Negligence	318	1,495
Fraud	14,789	34,864

(Note that abatements can be higher than assertions for a number of reasons. For instance, if one very large assessment is abated, it can distort the average for all others. The figures reflect the average dollar amount of all abatements by category.)

AVERAGE DOLLAR PENALTY
1987 Fiscal Year

Penalty	Average Assessment	Average Abatement
CORPORATIONS		
Failure to file	$ 3,188	$10,172
Failure to Pay	598	1,821
Estimated Tax	1,442	7,007
Bad Check	32	213
Negligence	8,497	37,363
Fraud	64,514	602,406
EMPLOYMENT		
Failure to file	$ 334	$ 845
Failure to Pay	74	166
Federal Tax Deposits	704	1,520
Bad Check	24	103
Fraud	4,875	1,667

d. Which computer generated penalty assessments can be abated? Which assessments cannot? For each penalty that can be abated, please provide the number of abatements, the amounts, and the reason for abatement.

RESPONSE: All computer-generated assessments can be abated when appropriate. We believe that abatements most often occur because taxpayers furnish additional information that was not available when the return was processed, either in response to our notice, or for other reasons. The criteria for abatement of computer-assessable penalties are shown below. The numbers and amounts of abatements were furnished in the tables provided earlier with respect to questions one and two.

PENALTY	ABATEMENT/WAIVER BASIS
6651(a), Failure to File Timely	Reasonable cause and not willful neglect
6651(b), Failure to Pay	Reasonable cause and not willful neglect
6652, Daily Delinquency Penalties	Reasonable cause and not willful neglect
6654 & 6655, Estimated Tax Penalty	Less than $500 tax; No prior year tax; Casualty, disaster, or against equity and good conscience; Newly retired or disabled; Amount at least equals last year's tax; Amount is at least 80% (or 90%) of tax; Seasonal income exceptions
6656, Federal Tax Deposit	Reasonable cause and not willful neglect
6657, Bad Check Penalty	Good faith; Reasonable cause
6676, Failure to Supply Taxpayer Identifying Number (TIN)	Reasonable cause and not willful neglect; Due diligence (for interest, dividends, and royalties)
6698, Failure to Provide Partnership Information or File a Partnership Return	Reasonable cause

e. Do the abatement ratios for computer assessments reflect a high error rate in comparison to other penalty assessments or do the figures indicate proper application of abatement criteria after initial correct assessments? Please provide an explanation.

RESPONSE: Abatement rates are not synonymous with errors. The reasons for an abatement, especially an abatement of a failure to file, failure to pay or estimated tax penalty, are such that the assertion may have been fully proper and correct, based upon the information available at the time of assertion' and properly abated when the taxpayer provides further information.

The General Accounting Office, in their report on IRS dated May 22, 1984, concluded that "IRS generally does a good job when abating civil penalties--and has made recent improvements." In that report, which focused on penalty abatements, GAO made no recommendations because they felt that IRS was making improvements where appropriate.

The presence of significant abatement rates may indicate that the system is working, that taxpayers are being heard when they submit requests for abatement based on reasonable cause or other information such as failure to properly credit payments or errors made during the processing of the return or other document.

f. What does the Service do to monitor and improve the accuracy of computer penalty assessments?

g. What are the principal causes of error in computer assessments?

RESPONSE: The Service uses a number of methods to monitor the quality of its programs, including the appropriateness of penalty assessments. Among them:

-- Most IRS computer programs (i.e., IRS-written software) are reviewed and revised annually or more frequently if there are identified problems. Those computer programs are first tested by our programming area, then by a team as part of the overall systems acceptability test of all computer programs, and third, in a parallel or live mode as the new programs go into actual operation. Even after these computer programs are up and running satisfactorily, Resident Programmer Analysts at the National Computer Center and at each service center monitor the operation of the programs to ensure that consistency and validity are maintained.

-- In the field, computer-generated notices are sample reviewed for accuracy before mailing to taxpayers. Quality assurance programs use sample work-in-progress checks to make certain information going into IRS computers--data likely to trigger or suppress notices to taxpayers--is entered accurately.

-- Taxpayer responses to notices are tracked for accuracy of penalty assessments, and quality assurance programs sample how we handle those taxpayer responses. Behind this activity is our Problem Resolution Program, to which taxpayers have recourse when they believe we haven't done the job right the first time. Trends identified in these control systems result in systemic reviews and, where necessary, correction or alteration of the system.

-- The Service makes use of program reviews, operations reviews and internal audits. Program reviews assure that our program designs are comprehensive, on target, and current. Operations reviews assure that program activities are being handled properly and consistently in the field. Internal Audit uses experienced IRS personnel not associated with specific operational programs to verify the quality of program design and program execution.

We are aware that there are errors in processing data to the computer, generally directly related to the transcription of data during the processing cycle. One error in computer generated assessment of penalties is the human failure to identify statements of reasonable cause/due diligence attached to returns or documents prior to processing. This failure results in not placing codes on the documents, and in the data base, which, if done properly, would cause the computer to bypass the penalty computation. Errors of this type cause taxpayers to contact the Service to request an abatement.

h. Explain whether taxpayers are paying erroneously assessed penalties out of fear, misunderstanding or to avoid the trouble and expense of correcting an erroneous assessment.

RESPONSE: We do not know the extent to which this may be happening, although we do believe that some people simply pay an assessment out of fear, because it is easier to pay than to contest, or because they do not understand the notice and decide not to question it. However, the high rate of correspondence and requests for abatement relating to penalty notices indicate that many taxpayers will challenge an adjustment if they either do not believe it is correct or understand it. We also know that taxpayers are frustrated when they do not understand a notice. For this reason, one major goal of the Commissioner's Penalty Study is to look at ways we can improve compliance with the tax laws through better administration of the penalty provisions, including publicizing the requirements of the law which give rise to penalties; possible use of warnings for first time violators; ensuring that taxpayers are aware of their rights of appeal; and educating taxpayers in the full operation of the penalty schemes. We hope that this effort, coupled with other aspects of our study, will result in the diminution of penalties and related correspondence.

i. Does the Service post-review penalty assessments to determine if taxpayers are paying erroneously assessed penalties?

RESPONSE: While not specifically designed to quality check penalty assertions and notices, the Service has a number of quality systems in place in the processing stream to ensure that systemic errors, especially those involving erroneous notices to taxpayers, are caught and corrected. These include the Notice Review Process, whereby a sample of all adjustment notices are reviewed, together with the documents pertaining to the subject taxpayer and return, by an experienced tax examiner. As errors are identified, efforts are made to provide additional training, clarify instructions or report computer programming deficiencies as the situation warrants. While no system can be error free, we are working to ensure that errors are identified and corrected.

j. Are penalties subject to review preferable and inherently more fair than ones generated by a computer? Please provide an explanation.

RESPONSE: Based upon our experience it does not appear to make much difference whether taxpayers receive a bill or a notice of intention to bill. Penalties cause consternation when they imply wrongdoing. Taxpayers are provided with opportunities to contest notices with which they disagree. We believe that system generally works well, although we are considering ways to make the notices more understandable and better ways of informing taxpayers of their rights to challenge incorrect notices.

Pre-assessment notification has the potential benefit of allowing the taxpayer to provide information prior to being subjected to assessment. This may_result in the tangible benefit of avoiding erroneous assessments. It also may result in the intangible benefit of the fostering of goodwill, or improving the image of the Service and the government, and therefore affect a taxpayer's willingness to comply.

However, taxpayers may not perceive much difference between a proposed assessment (such as a CP 2000) and an actual assessment with a right of appeal. The present system seems to work whereby a taxpayer can attach information which is relevant to abatement of the penalty to the return; can respond to the notification of penalty assertion with such information; or, finally, can exercise his/her appeal rights either administratively or judicially.

Some penalties, those subject to deficiency assessment procedures (such as the negligence, understatement, fraud penalty, etc.) are only generated by manual methods, and are subject to review in our various quality review programs in our Compliance functions. We do not believe that these penalties are inherently more fair than penalties which the computer assessment process can generate. Nor do we believe that the taxpayer has less opportunity to be heard in a 'computer generated' penalty situation than in the other types.

ATTACHMENT

THE PROCESS OF ASSESSMENT OF A PENALTY

The current status of the IRS's administration of the penalty program, and the checks and balances built into the system can best be understood in the context of the way IRS processes a return, asserts a penalty and ensures that errors in the process are kept to a minimum. Using the estimated tax penalty provided for in section 6654 of the Internal Revenue Code as an example, the process is as follows:

When the taxpayer files a return with insufficient credits for withholding or estimated taxes, he can file Form 2210, which explains why an estimated tax penalty is not due, or helps him calculate the appropriate amount of estimated tax penalty that is due. If the Form 2210 is not included with the return, the IRS, through its processing programs, calculates the penalty based on information from the return or in the computer's data base for that tax account.

The return is first handled in the remittance section where any check is removed and deposited. It then goes to a tax examiner who reviews the entire return and enters codes on the return or other document for use by the person who enters data into the computer. During this process, the tax examiner determines if there is a Form 2210, or other information attached to the return which might relate to the application or non-application of any penalty. The work of the tax examiner is monitored for quality purposes by senior personnel or managers through sample review.

Next, information from the return and the "edit" document is keyed into the computer. Two quality systems are in place to ensure that errors are caught and corrected. The data transcriber's work is subject to sample review (the size of the sample being determined by such factors as experience, prior error rates, etc.) and, if errors are found, total review. Additionally, part of the data is actually entered twice, by different transcribers, to ensure consistency and validity.

Once the computer has the data necessary to perform its calculations and data manipulation, the computer asks a series of "yes/no" questions. Based upon the responses to those questions, the computer produces necessary notices to the taxpayer, and codes the account to reflect assessment of the penalty. To ensure quality of actions by the computer in this process, the Service controls the programming, through testing, continual monitoring during implementation, and frequent consistency checks during the processing cycle.

When the computer effects issuance of the bill, an examiner screens it to ensure that it is legible. Some of the bills are more thoroughly reviewed in a sampling where the entire return package is scrutinized to ensure that the billing is correct. The volume of notices precludes us from doing more than a sample review, but information from those samples enables us to spot error trends or problems.

Whenever a bill is sent for a penalty, especially an estimated tax penalty, the bill is accompanied by a Form 2210, the instructions, and information on how to pay the amount due or how to notify us if the bill is incorrect or if the taxpayer believes the penalty should be abated. Information is also provided on how the penalty can be appealed, if appropriate.

REVIEW OF THE CIVIL PENALTY PROVISIONS CONTAINED IN THE INTERNAL REVENUE CODE

THURSDAY, JULY 28, 1988

House of Representatives,
Committee on Ways and Means,
Subcommittee on Oversight,
Washington, DC.

The subcommittee met, pursuant to notice, at 9:10 a.m., in room B-318, Rayburn House Office Building, Hon. J.J. Pickle (chairman of the subcommittee) presiding.

Chairman Pickle. Good morning, everyone. Before we start the hearing this morning, the Chair would like to recognize the gentleman from Washington, Mr. Chandler, who is now a newly assigned member to this Oversight Subcommittee, and we are pleased to have you here with us this morning, Mr. Chandler. Welcome to the subcommittee.

Congressman Schulze is on his way here to the subcommittee hearing. Now that Mr. Swain, the "late" Mr. Swain, has arrived, we will proceed.

This is the second in a series of hearings to consider the fairness and effectiveness of the current structure of civil penalty provisions in the Internal Revenue Code.

Last March, the subcommittee heard testimony from a variety of witnesses, including the Internal Revenue Service, who were concerned about the complexity, severity, and the sheer number of penalties currently contained in the code. Now it is time for the subcommittee to take the next step in the complicated process of making our penalty structure an effective but fair tool in ensuring compliance with the Tax Code.

To help us in this all-important endeavor, we will hear today from a number of distinguished witnesses on some specific penalty issues, including third-party information reporting penalties, penalties applicable to employee plans, and penalties affecting individuals and small businesses. These witnesses, and the witnesses we will hear from in later hearings, will help us to focus on particular areas in this tangle of penalties which need our scrutiny. I certainly want to thank them for being here today.

I am also pleased that today's hearing will mark the first public presentation of the results of the recent survey undertaken by the Small Business Administration concerning penalties imposed by the Internal Revenue Service on employment returns. This survey has revealed a disturbingly high number of erroneous penalties, and I know we look forward to taking a closer look at that report as presented to us by Mr. Swain.

Finally, we will receive recommendations for reform of the penalty system, presented today for the first time by the American Bar Association. This set of recommendations is remarkable in that it addresses the overall picture of the penalty system instead of focusing on patching up one or two problem areas. The recommendations should be very useful to the subcommittee, and we are, of course, delighted to have them. So I think it will be of interest today to note that we are receiving some recommendations from the Small Business Administration and some recommendations from the American Bar Association, which is for the first time some concrete proposals. And we will take them into consideration.

Now, we know we have got a problem. The current penalty structure is a confusing morass of complex, overlapping penalties that are often unduly harsh or just plain irrational. Now, we need to start picking this tangle apart, looking at those areas which are causing the most headaches, and thinking about concrete solutions. With the help of these witnesses, as well as witnesses to be heard from in future hearings, I am confident that we will be able to recommend a more fair, effective, and rational penalty system.

Now, Mr. Schulze, do you care to make any statement at this time?

Mr. SCHULZE. Mr. Chairman, I join you in opening our second hearing on civil tax penalties. At our first hearing, we received testimony from the administration on the structure and policy of the tax penalties. The message was that the primary purpose of tax penalties was to improve compliance by taxpayers. In order to improve taxpayer behavior, I think it is essential that penalties be easy to understand, perceived as fair, and practical to administer.

Regrettably, our March hearings revealed too many instances when the current penalties seemed confusing, unfair and difficult to administer.

The emphasis at our March hearing was on the penalties which applied to a taxpayer with respect to his own tax liability. Today's hearing will build on our March hearing. Today, we will review the penalties related to the taxpayer's responsibility to report information on third parties to the IRS.

The traditional third-party reporting requirements have involved wages paid to employees and interest and dividend payments. In recent years, the reporting requirements have increased. For example, expanded reporting is now required on many residential real estate transactions, on barter exchanges, by recipients of mortgage interest, by business payments for services received, and on the transfer of certain partnership interests. The origin of the expanded reporting requirements can be traced to deficit reduction tax acts in 1982 and 1984 and the Tax Reform Act of 1986.

The motivation behind the expanded reporting often was to improve compliance and curb the underground economy. Today, I am eager to learn how smoothly the new reporting requirements are being implemented. If the reporting cannot be implemented in a reasonable way, then it may be counterproductive.

Next, I am interested to learn how the IRS treats requests to waive the reporting penalties. Is the Service understanding, flexible, or is it rigid? Third-party reporting improves the ability of the IRS to enforce the tax law and improve compliance, but it does have its shortcomings. It drafts most businesses into serving as an involuntary army of unpaid enforcement agents. It is an army which receives no medals for carrying out a difficult battle plan, but it may be court-martialed for its failures.

Third-party reporting may be a special burden on small businesses. Many small businesses may not fully appreciate their reporting responsibilities or may not have the automated accounting systems essential for practical compliance. I will also be interested to learn how small business is implementing the expanded reporting requirements.

Mr. Chairman, I look forward to hearing today's witnesses.

Chairman PICKLE. Thank you, Mr. Schulze.

We have asked that some additional chairs be brought in so that our guests this morning will have a place to sit. It will be a few minutes before they will be here, but they will be here.

The Chair also would want to observe that during the hearings today, Mr. Flippo will chair the hearing at different intervals. He is an experienced legislator in this field, and we are pleased to have him take the lead here today.

Now, our first witness is Mr. Frank Swain, who is the Chief Counsel for Advocacy, representing the Small Business Administration. I understand he has got some facts to make and some recommendations to present to us.

Mr. Swain, we ask that you limit your remarks, to summarize them in general terms, to five minutes. We are not going to limit you to that, but we have several other witnesses, and the American Bar is represented by several other speakers. So if you can, summarize it in that time, and if you need additional time, we are certainly not going to cut you off. So we are pleased to have you, Mr. Swain.

STATEMENT OF FRANK S. SWAIN, CHIEF COUNSEL FOR ADVOCACY, U.S. SMALL BUSINESS ADMINISTRATION

Mr. SWAIN. Thank you very much, Mr. Chairman, and I will certainly summarize my statement, which is, of course, available in the record.

I want to congratulate you and the members of this subcommittee for holding the second in a set of hearings on civil tax penalties. It is an extremely important issue for small business. Widespread attention has been focused on reform of the civil tax penalty structure, and for good reason. The penalties imposed on businesses and individuals have steadily increased in both numbers and severity. The traditional philosophy is that stronger penalties and stronger enforcement invariably lead to greater respect for the taxing system, but the consensus among the small business community is that the proliferation and implementation of these penalties may well have had the opposite effect.

I think it is particularly important to note, Mr. Chairman, that principles of fairness and equity, which are often discussion points in tax policy debates, take on extraordinarily visible and immediate application where penalties are involved. Small employers are frustrated with penalties while struggling to comply with exceedingly complex and changing tax laws.

I am concerned that instead of instilling respect, the penalty system, or at least parts of it, has contributed to a serious erosion of faith in our voluntary tax system. I believe that penalty reform is the rightful successor to substantive tax reform undertaken and originated in this committee 2 years ago.

Mr. Chairman, I would like to briefly address two issues this morning: payroll tax penalties and COBRA penalties. I will spend the principal amount of attention on payroll tax penalties. Payroll-related penalties have the single greatest impact on small business. There are about 5.7 million payroll taxpayers, and they remit payroll tax on a variety of schedules, depending on the trigger requirements in the current laws. These collections constitute over three-quarters of all the revenue received through taxes.

Now, every year, the IRS assesses a very large number of payroll tax-related penalties. For the past 6 years, the IRS has assessed an average of more than 10 million payroll tax-related penalties per year. The high year was 1985 with 11 million penalties, and the record seemingly improved somewhat, or the record of the taxpaying community improved in 1986. But in 1987, we are back up to the 11 million figure.

The IRS also reports that each year between 20 and 25 percent of these penalties are set aside. That is to say, that either somewhere around 1 out of 4 or 1 out of 5 penalties is set aside after the penalty is assessed, or in the words of administrative practice, abated. Last year penalties assessed resulted in a total net liability of more than $2.4 billion.

We believe that for a substantial majority of the taxpayers assessed such penalties for payroll taxes, the penalties were erroneous. But it is difficult to figure out whether that is true or not. What the IRS tells us and everybody else in their annual reports is how many penalties they assessed, more than 10 million per year, and how many they abated. And that is all we know, really, from the IRS. We do not know why the ones that were abated were abated. There are two probable reasons: either the IRS made a mistake or the taxpayer made a mistake that was so minor or inadvertent that the IRS chose not to declare a penalty.

So we attempted through a survey to shed further light on this question.

We do recognize that abatements may be caused by a number of factors, and our real interest is trying to get to the bottom and decide whether the factors are processing factors or taxpayer factors. Basically, a survey which was done based on the 1985 tax year showed that 26 percent of the taxpayers surveyed claimed that they had received assessment for employment returns. That is, about 1 out of 4 payroll taxpayers received penalties. And two-thirds of those that received penalties thought that they were erroneous. In most cases, they fought those with the IRS. They protested. And in most of the protest cases, they were successful. The exact figures are in our report, and there is a chart that illustrates them.

The bottom line seems to be that there are a lot and an increasing number of payroll tax penalties. The number forgiven by the IRS has also increased as well.

Now, I suppose the two perspectives are: from the taxpayer perspective, these figures would indicate that the IRS is assessing a lot more penalties in an unjustified way and, when challenged, they forgive them. I am sure the Service would reply that the increasing abatements reflect that they are more sensitive and they are willing to forgive more errors.

I am sure the truth lies somewhere in the middle. We do not know exactly where in the middle the truth is. But we do think the fact that such a significant number of penalties that have been assessed are abated indicates that there is something in the system that can be improved. We have three categories of specific recommendations: One, improve taxpayer assistance; two, improve IRS quality control; and, three, instill greater tolerance for inadvertent errors.

I might mention, Mr. Chairman, we do have some specific examples, including one example of a December 1987 notice in which a $382 penalty was assessed for an underpayment of 5 cents. So that goes to illustrate our third point, I suppose: greater tolerance for inadvertent or minor errors.

We do believe the taxpayers are continually frustrated because they cannot get a live person on the phone; or if they get a live person, that is not the same person they spoke to previously, or that is able to follow their case from one point to another.

One of the things that our survey revealed is that an exceedingly large number of taxpayers, after initially protesting and, indeed, in some cases settling the penalty, continued to receive notices from the IRS. There seems to be the phenomenon of once the penalty mechanism has started, regardless of the response of the taxpayer, whether they agree to pay up or whether they produce canceled checks to indicate that there is no further tax or penalty due, the computer seems to keep chugging along in very many cases. Certainly not all cases, but at least one-third of the people indicated that after they had made contact with the IRS and attempted to settle their cases, they received at least three additional computer notices for penalties or interest.

We also suggest that the IRS notices themselves need to be reviewed for clarity and explanation to the individual taxpayer. Mr. Chairman, I do not think that this is by and large a problem for a major business that has highly computerized payroll facilities and probably direct deposit payments and magnetic tape reporting. I believe that this is primarily a difficulty for the smaller business that in many cases has the traditional bookkeeping approach. They may have a rounding error or they may have difficulties coping with some of the changing payroll reporting schedules. And when they do make a mistake, it is in many cases inadvertent.

The final point that I would specifically suggest is that the IRS consider a tolerance; that the IRS, which seemingly can track everything, ought to be able to track how many times an individual payroll taxpayer makes a mistake, and maybe adopt a policy that every dog gets one bite, every taxpayer gets to make one inadvertent mistake below a certain level or threshold without any penalty.

And then if the taxpayer shows repeated ignorance or recalcitrance or just sloppiness in paying their taxes, then increasing amounts of penalties would ensue.

We have met and discussed this study a lot with the Internal Revenue Service. I think that they agree that there is a problem. I do not think that they endorse or agree with all of the conclusions in our study. And I might also add, Mr. Chairman, that it is important to realize that to the extent that the Service can take our study or any of the questions that we ask and, by examining their own data, come up with better or more precise answers, we think that that would be a very important development. The fact is they have not yet done so, and that is why we went ahead and did our study.

We think there is a lot that can be done from an administrative perspective to lessen the number of payroll tax penalties and to make more predictable the system for abatement.

I also would mention, Mr. Chairman, our statement does have some discussion of COBRA penalties. I realize they are currently the subject of some provisions in the Technical Corrections Act. That is obviously a statutory matter rather than a regulatory matter. For reasons that we set forth in this statement, we think that that penalty structure is a very poor one. And in looking at this issue, I was astonished to realize that the joint committee apparently did a revenue projection on the proposed changes in the COBRA penalties, which at least implies that the penalty structure, among other reasons, is meant to raise revenue. I think that even the IRS internal studies suggest that the purpose of penalties is to induce compliance with the tax system and not to raise revenues.

To the extent the taxpaying public feels that a purpose of penalties is to raise revenues, that clearly sends a difficult and troubling signal to the taxpaying public. We certainly commend the committee for its interest in rationalizing and examining the penalty structure. We would be happy to work with you and certainly with the Service, and I would be happy to respond to any questions that you may have this morning.

[The prepared statement and attachment follow:]

U.S. SMALL BUSINESS ADMINISTRATION
WASHINGTON, D.C. 20416

OFFICE OF CHIEF COUNSEL FOR ADVOCACY

TESTIMONY OF
HONORABLE FRANK S. SWAIN
CHIEF COUNSEL FOR ADVOCACY
U.S. SMALL BUSINESS ADMINISTRATION
BEFORE THE
SUBCOMMITTEE ON OVERSIGHT OF THE
COMMITTEE ON WAYS AND MEANS
ON CIVIL PENALTY PROVISIONS
JULY 28, 1988

Mr. Chairman and Members of the Subcommittee on Oversight:

I am pleased to appear before you today to contribute my views on the need for civil tax penalty reform. I would like to highlight today two specific areas where penalty reform is most needed from the small business perspective; payroll-related penalties and the penalties for violation of the COBRA continuation coverage requirements. As Chief Counsel for Advocacy, U.S. Small Business Administration, my mandate is to represent the concerns of small business in Federal policy discussions. My views here today reflect those of the Administration.

The Subcommittee is to be commended for continuing its series of hearings on this topic that were begun in late March. As you know, widespread attention has been focused on reform of the civil tax penalty structure and for good reason. Studies of our penalty system are now being conducted by both houses of Congress, most major practitioner groups, and the Internal Revenue Service Executive Task Force. For the last decade and a half, the penalties imposed on businesses and individuals have steadily increased in both numbers and severity. The nearly 150 separate sanctions currently in the Internal Revenue Code (IRC) have evolved from the traditional philosophy that stronger penalties and stronger enforcement invariably lead to greater respect for the taxing system. The consensus among the small business community, however, is that the proliferation and implementation of these penalties has had the opposite effect.

The principles of fairness and equity, often mere abstractions in tax policy debate, take on a very visible and real application when penalties are involved. Small employers are being frustrated with penalties while struggling to comply with exceedingly complex and changing tax laws. The complexity of the tax penalty structure, the overlap of its various provisions and the severity of the sanctions have resulted in a penalty structure which is both difficult for the IRS to enforce and for the small employer to comprehend. Instead of instilling respect, it has contributed to a serious erosion of faith in our voluntary taxing system. Penalty reform is the inevitable and rightful successor to the substantive tax reform undertaken two years ago. The Subcommittee's focus on this subject is both warranted and timely.

Oliver Wendall Holmes once aptly stated that, "taxes are what we pay for a civilized society." Inherent in this concept, however, is the understanding that a civilized society must strive to enforce these taxes in the most civilized manner. Needless to say, the efficient operation of the Federal tax deposit system and taxpayers' perceptions of the fairness of the penalty system in general are crucial to our voluntary taxing system. There can be little doubt but that we must vastly improve upon this system, not only for the benefit of small business, but for the continued integrity of our taxing structure.

I. Payroll Tax Reform

The principal area of concern from the small business standpoint is in the administration of payroll-related tax penalties. Payroll-related penalties have the single, greatest impact on small business. Employment taxes are paid by more than 5.7 million businesses and collectively constitute over three-quarters of all revenue received through taxes. Every year, however, the IRS assesses an extremely large number of payroll tax-related penalties. For the past six years, an average of 10 million such penalties have been assessed annually, and each year about 20 percent of the penalties have been abated or set aside for one reason or another. Last year, those penalties resulted in a total net liability of over \$2.4 billion.[1] Moreover, according to a study recently completed for the SBA Office of Advocacy,[2] a substantial majority of the taxpayers assessed such penalties perceived that they were erroneously assessed. I believe that statistics such as these reveal significant deficiencies in our current payroll tax penalty system and illustrate the need for change in the administration of these penalties. Reform of the payroll tax system was voted among the Final Recommendations of the White House Conference on Small Business conducted in 1986.

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[1] IRS Commissioners Annual Reports.

A. Penalties Imposed Relative to Employment Returns

There are essentially three penalties which can be assessed against an employer in connection with employment returns; Failure to Timely File, Failure to Timely Pay, and Failure to Timely Deposit. Each penalty is substantial, and can be applied separately or in combination.

If an employer fails to timely file either the Form 940 or Form 941 without reasonable cause, 5 percent of the amount required to be shown as tax on the return can be assessed as a penalty. This penalty cannot exceed 25 percent of the total tax required to be shown.[3] If the employer fails to timely pay the tax when due, a penalty of 0.5 percent of the amount is prescribed for each month or fraction of the month. Furthermore, if the employer fails to pay any deficiency within 10 days of the notice and demand for such payment, an additional penalty of 0.5 percent applies for each month. The amount of any penalty for Failure to Timely Pay, as in the case of Failure to Timely File, cannot exceed 25 percent in the aggregate of the amount subject to the penalty.[4] Finally, the Failure to Timely Deposit penalty is imposed on any person who fails to make timely deposits of social security, unemployment and withheld income taxes to the authorized financial institution.[5] This penalty is equal to 10 percent of the amount of underpayment of tax without regard to the period during which the underpayment continues. The penalty will be assessed in all cases where the deposit is less than 99 percent of the required amount, unless the taxpayer is able to demonstrate reasonable cause for abatement.

B. IRS Data on Payroll Tax Penalties

The Internal Revenue Service frequently assesses employment-related penalties against the 5.7 million business taxpayers. As shown in attached Exhibit 1, which tabulates consecutive IRS Annual Reports, an average of over 10 million payroll-related penalties were asserted each year from 1982 to 1987. On the average, 20 percent, and as high as 29 percent of these penalties have been abated during the same period. Last year alone 11.1 million penalties were assessed against business taxpayers, mostly small employers. While the overall amount of penalties assessed has declined slightly in the past decade, the ratio of abatements to penalties has generally increased. Almost half of this increase took place in 1986 alone.[6]

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[2] Survey of Erroneous Penalties Imposed by IRS Relative to Employment Returns, Brown Associates, Inc., April 25, 1988.

[3] 6651(a)(1).

[4] 6651(a)(2) and (3).

[5] I.R.C. §6656(a); Obligation imposed by I.R.C. §6302(c).

[6] IRS Commissioners Annual Report.

There does not appear to be an effective policy for reducing the number of penalties assessed and abated. Examination of trends with respect to penalties and abatements for specific violations demonstrates the haphazard character of penalty enforcement. While the number of Failure to Timely File penalties have increased only slightly from approximately 2 million to about 2.6 million, the percentage of these penalties which have been abated has increased more than five-fold, from 6 to 33 percent. Also, penalties assessed for Failure to Pay have been steadily increasing for the past decade, from 2.3 million in 1978 to 5.2 million in 1986, and over the same period, the percentage abatement rate for these penalties has nearly doubled, from 13 to 23 percent. Last year, the total Failure to Pay assessments decreased slightly, but the abatement rate remained approximately the same. The only penalties that have shown a marked decrease in number over the years are those for Failure to Timely Deposit, from over 5 million in 1984 to under 1 million in 1986. However, during the same period the percentage of assessments issued for such penalties almost doubled, from 19 to 36 percent. Moreover, in the newly released 1987 Commissioner's Annual Report the number of penalties imposed for untimely deposits in 1987 more than tripled over 1986.

It is important to note that the abatements do not necessarily reflect errors on behalf of the IRS. Assessments can result from numerous problems along the chain; including, taxpayer errors in completing the FTD form, bank errors, Federal Reserve district errors, or IRS errors in processing the returns or the data from the banking system. Omissions or commissions within taxpayer's control giving rise to a penalty stem from willful conduct, from negligence or from clerical or innocent errors. The IRS can abate a penalty if the taxpayer proves the IRS was in error or if the taxpayer can show that the offense for which it was imposed resulted from reasonable cause and not from willful neglect. Every abatement, however, irrespective of cause, represents additional expense and frustration for the taxpayer and for the IRS who must process the abatement. Abatements caused solely by IRS error are the most troublesome: they not only require taxpayers to incur substantial costs but exact an intangible societal cost by deteriorating taxpayers' perceptions of the fairness of the system. Inadvertent errors on the part of the taxpayer may occur with such frequency that they reflect more upon the complexity of the system than upon remediable conduct. Issuance of penalties in such cases may have little general or specific deterrent effect.

C. Taxpayer Obligations Under the Payroll Tax System

Payroll taxes, which are collected in conjunction with Form 941 and the related deposits made through the Federal tax deposit (FTD) system, comprise the bulk of all revenue collected in the U.S. This includes the amounts withheld from employees' wages for income and social security taxes as well as employers' share of social security taxes. Income taxes withheld, along with the employers' and employees' portions of social security taxes, must be deposited to the Treasury Departments' account at a bank at specified times.

The frequency with which these deposits must be made depends on the amount of undeposited taxes held by the firm. Specifically, the deposits must be made at the end of the quarter where withheld taxes are less than $500, within 15 days after the end of the month if the taxes are between $500 and $3,000 and, within 3 banking days after each payroll period if the taxes exceed $3,000. Similar frequency rules apply to Federal Unemployment Tax Act (FUTA) payments. In case these deposits are not made in a timely fashion, deposited to the wrong account, sent to the wrong address or not posted properly a penalty will attach. In addition, the amounts deposited must be reported to the IRS quarterly with Form 941 and annually with Form 940. A monthly report on Form 941M is required if the taxpayer fails to file an appropriate Form 941. The information to be provided by the employer with respect to each return is set forth in Exhibit 2.[7]

D. A Look Behind the Penalty Assessments

1. The High Number of Erroneous Assessments

Given the large number of businesses affected by penalty assessments, the high abatement rate and the severity of the penalties imposed, the Office of Advocacy commissioned a study to shed some light on the reasons for these penalty assessments. The survey, recently completed by Brown Associates and released today, consisted of a mailing to 8,500 businesses on our small business master establishment list. Data from the survey, as summarized on the following page, show that 26 percent of the taxpayers surveyed claimed they had received assessments for employment returns, and that 64 percent of these penalties were reported to be erroneously assessed. Of the taxpayers reporting penalty assessments, 89 percent reportedly protested and 66 percent of those protests were reportedly successful. This suggests that an intolerably high percentage of abatements result from error outside the taxpayer's control.

The survey questionnaire has also allowed us to explore the problem from several perspectives; for example, (1) the penalty assessments by IRS region; (2) the penalties imposed by Form type; (3) the number of notices sent after protest; (4) the penalties assessed by employee size; (5) the method of proof offered by the taxpayer; and (6) the erroneous penalties assessed by industry. Most notably, the results showed that in 35 percent of the reportedly erroneously issued penalty assessments, 3 or more notices were claimed to have been received by the taxpayer, often after the IRS agreed that the assessment was erroneous. In the vast majority of the erroneous assessments, taxpayers reported offering proof, such as a cancelled check (48 percent), employment records (5 percent) or an FTD slip (8 percent), that clearly indicated an IRS or bank error. The percentage of erroneous penalties by industry indicates that the construction industry had received the largest number of assessments, 41 percent as opposed to 26 percent overall. Tabulations of this information are included in attached Exhibit 3 on Tables 1 through 5.

2. Suggestions for Reform

In addition to shedding light on the penalty process, the survey asked taxpayers to recommend procedural changes to ease the burden of the collection process. Their suggestions, as revealed by the survey, point to three general areas for reform: improved taxpayer assistance, improved IRS quality control and greater tolerance for inadvertent errors.

Almost one-fifth of the respondents indicated that the IRS should more expeditiously take action on taxpayers' inquiries regarding payroll tax penalties. About 17 percent of the respondents suggested that correspondence from the IRS be written in easier to understand terms. This includes instructions relating to filing and Federal tax deposit requirements as well as instructions relating to the penalty. About 13 percent of the taxpayers suggested that a specific, knowledgeable person with a toll-free number be assigned to individual cases. On a

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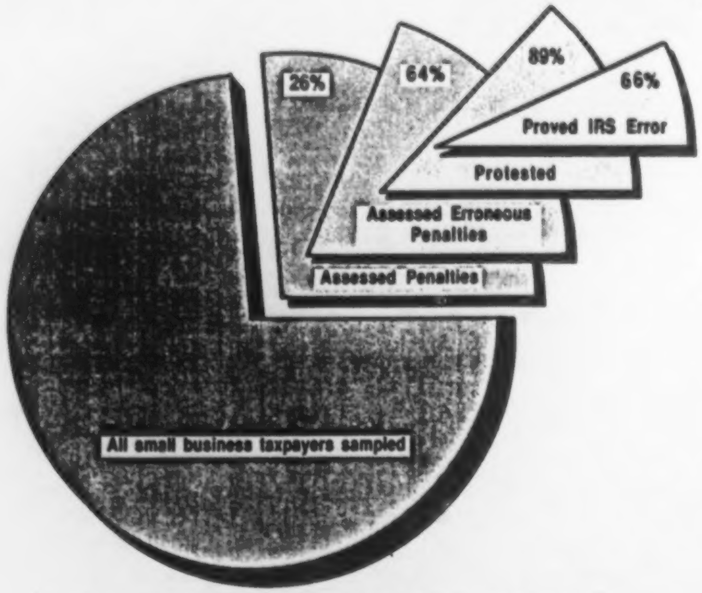
[7] Filing requirements are specified in IRS Circular E.

BROWN ASSOCIATES: SURVEY OF ERRONEOUS PENALTIES IMPOSED BY IRS RELATIVE TO EMPLOYMENT RETURNS*



*Survey results are based on claims of taxpayers.

This survey was conducted by Brown Associates for the U.S. Small Business Administration. Survey of Erroneous Penalties Imposed by IRS Relative to Employment Returns, Brown Associates, Inc., April 25, 1988.

descending scale of frequency, taxpayers suggested that the IRS assign better trained individuals to handle taxpayers questions with regard to payroll penalties, that there be less paperwork and forms and that Federal tax deposits be required on a less frequent basis. The suggestions by percentage of respondents are tabulated in Exhibit 4.

IRS could address these concerns by adopting certain administrative changes as proposed in the study. First, in order to be more responsive in its replies to taxpayers, the IRS should:

- Place a hold on further action, such as sending more notices or allowing the account to proceed to delinquent status, when a protest is received. The IRS should continue further action only after the issue is resolved.
- Review its notices and letters to improve clarity. This might be accomplished through focus groups studies similar to those that have been conducted in recent years for income tax returns. The problem might also be comprehensively considered by the Commissioner's Advisory Group.
- Specify in the notice of penalty the name of a particular individual to contact who will be assigned to the particular case. This person should be able to resolve the matter over the phone on first contact or by prompt reply.
- Provide a sufficient number of telephone lines for resolving payroll tax problems.
- Improve the training and supervision of personnel handling inquiries from taxpayers.
- Provide small employers educational materials specifically targeted for small business employment return problems.

Second, in order to reduce the number of erroneous assessments, the IRS should establish a quality control program aimed at improving the processing of FTD monies and returns at Federal Reserve Banks and processing centers. The IRS should also consider permitting an administrative tolerance of several days for determine whether or not a tax deposit is made in a timely manner.

Finally, and in addition to the changes recommended by the study, I suggest the IRS consider consolidating Forms 940 and 941. These Forms require duplicative efforts on behalf of both the taxpayer and the IRS. The information contained in these forms can be collected on a single form with less paperwork burden and less opportunity for error.

The Subcommittee should recognize that the problem of excessive payroll tax penalties is not caused solely by the lack of taxpayer education. As our survey noted, the majority of respondents indicated that the penalty was assessed in error. Even when the IRS initially agrees the penalty is in error, significant costs are incurred from the beginning of the process, protest, to the end of the process, abatement. In the attempt to mitigate problems which might stem from the lack of taxpayer familiarity with the deposit tax process, the SBA has been conducting joint workshops with the IRS. Our combined effort first began in 1975 with a Memorandum of Understanding between the two agencies. This agreement was recently renewed on March 12, 1987 with a Memorandum of Operations, and an IRS/SBA Task Force has been established to increase interagency cooperation at a national, regional and district level. Many of our District Offices conduct joint SBA/IRS education programs bi-monthly with specific attention to these problems.

The Office of Advocacy staff has been working with the IRS Commissioner's Office to develop appropriate administrative remedies to these problems as highlighted by the survey. Although no administrative changes have yet been made, we have received assurances that the Service will see to it that changes are brought about in the payroll system.

II. COBRA Penalties

The Subcommittee should look to reform of the penalties imposed for violation of the continuation coverage requirements for group health plans under the Consolidated Omnibus Budget Reconciliation Act (COBRA).[8] Under COBRA's technical requirements, most firms offering group health plans are required to continue to offer separated employees substantially similar health coverage, and to track and notify those persons of their options under the plan for a period of 18 to 36 months. At a time when small employers are being asked to assume more of the burden of America's escalating health care costs, the COBRA sanctions have put those businesses at a high risk of penalty when they attempt to do so. The fear of this penalty can discourage small businesses from providing health coverage altogether, in contravention of the legislative intent of COBRA.

A. Poorly Designed Sanctions

The sanctions for non-compliance with the continuation coverage requirements in COBRA have been the subject of extensive criticism. Over the last year, the proposed implementing regulation for COBRA, §1.162-26, has attracted over 1,300 comment letters highlighting the severe sanctions imposed by the regulation. These sanctions are misguided because they have little capacity to effect compliance. In designing the penalty, the revenue potential of the penalty collections may have been elevated above the need to enhance compliance.

Under COBRA, any violation of any of the detailed continuation coverage requirements, regardless of cause, will result in the inclusion of the value of the coverage in the highly-compensated employees' income (normally the employees who decide to establish the plan), and a denial of all employer deductions attributable to the maintenance of the plan for the entire year. These sanctions will apply even if a business fails to comply with the requirements for one employee, one day of the year. Because the proposed structure of the sanctions would punish a business for the entire year, no incentive is provided to a business to expeditiously correct defects in the plan, prospectively or retrospectively. Good faith efforts on the part of employers to correct a violation, no matter how technical the violation is, are not taken into account.

Furthermore, in limited circumstances, the sanctions may be imputed to all small businesses participating in a pooling arrangement, regardless of whether or not the party in violation of the requirements is related to the other participants. For example, if an employer is participating in a single group health plan where all participants qualify under the small employer plan exemption, the failure of one employer to qualify under the plan exemption may subject all participants to the COBRA continuation requirements. This problem was mentioned during the administrative hearing under I.R.C. Reg. Section 1.162-26.

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[8] I.R.C. §162(k).

B. Suggestions for Reform

Employers' attempts to avoid sanctions and to conform with the requirements under I.R.C. § 162(k) should be encouraged; however, the Department of Treasury believes that it has limited discretion to restructure the penalties in order to do so. On August 27, 1987, I filed detailed comments with the Treasury on this issue. As you know, the Committee is considering legislative changes to the COBRA penalty provisions. H.R. 4333, the House Technical Corrections Bill recently reported out of the Ways and Means Committee, is beneficial insofar as it seeks to redefine the sanctions to encourage taxpayer correction and to focus the sanctions to target proper parties. It is, in these respects, a step in the right direction.

One way to better ensure that employers continue to offer their separated employees health coverage would be to apply the sanctions proportionally, based on the number of days in which the business was not in compliance. An alternative would be to permit employer deductions and exclude the value of the coverage for the period of time remaining in the taxable year after the violation is corrected. The sanctions could also encourage employers to retroactively cure defects by permitting a partial reinstatement of deductions and a partial exclusion of the value of the policy where past violations are remedied. This partial reinstatement could provide incentives to cure defects by phasing out the recoverable deduction on a pro-rata basis as the taxable year comes to an end. The phase-out period could begin to run on the first day the plan fails to meet the COBRA continuation requirements. Additionally, sanctions should be applied only on a firm-by-firm basis. An employer should not be penalized for the action or inaction of a firm to which its only relationship is common participation in a health insurance pool. Finally, this sanction should apply only to highly compensated employees who at the time of the violation were in a position to know of and effect compliance.

Conclusion

The payroll tax system has yielded results which are perceived as unfair by small employers. According to IRS statistics, over ten million penalties are normally issued every year and 20 percent of these penalties are eventually set aside. These penalties are frequently issued without regard to the gravity of the error and often for inadvertent or clerical mistakes. Little or no administrative tolerance appears to apply in the administrative stage, and once a penalty is issued considerable time, frustration and effort must be expended before the problem is resolved. Moreover, our study suggests that an intolerable number of penalties are issued through no fault of the taxpayer, adding to deterioration of their faith in our penalty system. Regardless of whether or not the violation was technically within or without the control of the taxpayer, the costs to the taxpayer and to the system are devastating.

Our penalty system must exist to ensure that taxpayers adhere to the various provisions of the Internal Revenue Code. Enhancing compliance with the law, however, should be the sole purpose for such penalties, guiding their design and their administration. Penalties, such as those for payroll related taxes and for group health plan continuation coverage requirements, should never be designed or administered in such a way as to detract from this essential purpose.

EXHIBIT 1

EMPLOYMENT TAX RETURNS
PERCENTAGE OF PENALTY ASSESSMENTS WHICH HAVE BEEN ABATED*

Year	Untimely Deposit Assessed (1000)	Untimely Deposit Percent Abated	Delinquent Filing Assessed (1000)	Delinquent Filing Percent Abated	Failure to Pay Assessed (1000)	Failure to Pay Percent Abated	Total of Penalty Assessed (1000)	Total of Penalty Percent Abated
1987	3,477		2,577		5,055		11,108	
1986	985	36	2,614	24	5,182	23	8,781	25
1985	2,445	38	2,393	14	4,408	33	9,247	29
1984	5,159	19	2,406	11	4,257	27	11,902	20
1983	4,454	19	2,251	11	3,801	23	10,505	19
1982	4,649	14	2,280	9	3,417	19	10,345	15
1981	2,772	11	2,304	7	3,020	16	8,096	12
1980	3,013	8	2,194	7	2,633	17	7,839	11
1979	2,620	8	2,248	6	2,495	15	7,364	10
1978	2,051	8	2,080	6	2,371	13	6,502	9

*Source: Commission's Annual Reports for Each Year.

EXHIBIT 2

Withheld Income Taxes

In addition to information pertaining to noncash distributions and certain other information, records of employers subject to withholding on income must include the following information:

1. each employers name address and social security number;
2. the date and amount of each wage payment and the time period the payment covers;
3. the amount of each wage payment subject too withholding;
4. the amount of the withheld tax and the date it was collected;
5. if the taxable amount is less than the total wage payment, the reason why;
6. information concerning direct payment under an accident or health plan; and
7. withholding exemption certificates filed by each employer (Form W-4).

FICA

In addition to the information required to be filed for purposes of income tax withholding, employers must maintain the following information for social security tax purposes:

1. the amount of each wage payment subject to FICA;
2. the date and amount of social security tax withheld; and,
3. if the total wage payment and the taxable amount differ, the reasons why.

FUTA

Additional information required to be filed for Federal undmployment taxes includes:

1. the total amount of compensation paid to employees during the calendar year;
2. the total amount of compensation subject to FUTA and the reasons for any difference in the total amount paid to employees and the amount subject to FUTA;
3. the amount of tax paid into a state unemployment fund; and
4. the amount of tax shown on Form 940.

Source: Bureau of National Affairs, Tax Management Portflio, Volume 392, page A-88.

EXHIBIT 3

TABLE 1

PENALTY ASSESSMENTS REPORTED BY IRS REGION

IRS Region	Percentage of Taxpayers with Penalty Imposed	Percentage of Taxpayers with Penalty Having Penalty in Error	Percentage of Taxpayers with Erroneous Penalty Who Protested	Percentage of Taxpayers for Which IRS Agreed Penalty Was in Error
Southeast	24	61	95	74
Western	29	69	95	68
Mid-Atlantic	25	57	88	76
MidWest	29	77	94	59
Southwest	21	60	82	72
N. Atlantic	28	56	80	60
Central	28	61	85	66
All Regions	26	64	89	66

TABLE 2

PERCENTAGE OF TAXPAYERS CLAIMING PENALTY ASSESSMENTS BY FORM TYPE

FORM	Percentage of Taxpayers Who Had Penalty Assessments	Percentage of Erroneous Penalties for Taxpayers with Penalties
940 (1985)	29	68
941 (1986)		
1st Quarter	35	52
2nd Quarter	41	68
3rd Quarter	46	47
3 Quarters	13	42
2 Quarters	11	32
1 Quarter only	62	68

Table 3

NUMBER OF NOTICES CLAIMED TO HAVE BEEN RECEIVED AFTER PROTEST

Number of Penalty Notices Erroneously Sent	Percentage of Penalties that IRS Agreed were Erroneous	Percentage of Total Erroneously Issued Assessments
Zero	63	30
1	84	11
2	73	25
3	82	16
4 or several	20	6
5	67	3
6	100	2
7	100	1
Many	25	7

Note: This tabulations includes only one protested erroneous assessment per taxpayer regardless of the number of such assessments which were imposed

Table 4

PENALTIES REPORTED ASSESSED BY EMPLOYEE SIZE

Number of Employees	Percent of T/P with Penalty Imposed	Percentage of of T/P with Penalty Having Penalty in Error	Percentage of T/P with Erroneous Penalty Who Protested	Percentage of T/P For Which IRS Agreed Penalty was in Error
1	13	62	89	75
2	21	63	81	68
3	18	49	90	78
4	25	48	83	60
5 - 9	28	65	95	69
10 - 14	30	69	96	71
15 - 24	27	53	88	71
25 - 49	20	60	67	38
50 - 74	48	74	100	86
75 - 99	39	57	100	75
over 99	29	73	91	70
unknown	36	80	79	41
All Taxpayers	26	64	89	66

Note: T/P = Taxpayer

Table 5

PROOF CLAIMED TO HAVE BEEN OFFERED THAT THE PENALTY WAS ERRONEOUS

Type of Proof Offered	Percentage of Taxpayers Who Claimed Erroneous Penalties
Cancelled Check *	48
Employment Records	5
FTD Slip	8
Copy of Return	3
Letter of Explanation	13
Reasonable Cause	3
Other Reasons	4
No Reason Given	15

* Includes 15% which offered both cancelled check and one of the next four reasons.

Table 6

ERRONEOUS PENALTIES CLAIMED BY INDUSTRY

Industry	Percentage of All Taxpayers	Percentage of Taxpayers with Penalties	Taxpayers With Erroneous Penalties as a Percentage of Taxpayers with Penalties
Retail	22	22	62
Wholesale	6	22	54
Manufactureing	8	41	61
Construction	9	41	46
Transportation	2	38	76
Agriculture	2	12	67
Financial	2	13	100
Real Estate	4	22	70
Education	1	0	0
Professional Service	11	18	60
Other Personal Service	10	28	63
Food Service	3	28	60
Entertainment	1	0	0
Business Services	12	30	69
Non-Profit	2	10	100
Miscelleneous	3	23	86
Unknown	2	66	100

EXHIBIT 4

SUGGESTIONS BY RESPONDENTS

Suggestion	Percentage of all Suggestions
More Expeditious or Thorough Action or Reply by IRS	19
Clarify Instructions, Letters & Reasons for Penalty	17
Assign Specific Knowledgeable Person & Toll Free No.	13
More Competent IRS Personnel	7
Less Paperwork and/or Forms	6
Less Frequent FTD	5
Attitude of IRS Personnel is Arrogent or Intimidating	3
Change 1/8 Month -- 3 Day Rule	3
No Penalty for Few Days Late or 1st Time Error	3
Need to Educate Businesses re Forms & FTD Rules	2
Reduce Banking Errors	2
Don't Penalize Honest Errors	1
Verify that the Checked Quarter is Correct	1
Unknown	1
Not Acceptable Suggestion	17
Other	6

BROWN
ASSOCIATES INC.

SURVEY OF ERRONEOUS PENALTIES IMPOSED BY IRS RELATIVE TO EMPLOYMENT RETURNS

April 25, 1988

Final Report for
Contract SBA-1059-AER-86

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SUMMARY

Approximately one-fourth of the 9 million penalties assessed on employment tax returns by the Internal Revenue Service in 1986 were later cancelled, or "abated" -- largely because they were assessed in error. This study, based on a survey of small businesses, was undertaken for several purposes:

(1) To examine the reasons for the large number of erroneous penalty assessments on employment tax returns.

(2) To determine the extent to which small business taxpayers elect to pay erroneous penalty assessments instead of attempting to have the penalty removed.

(3) To suggest ways of easing the burden of IRS procedures on small businesses.

Data from the survey show that 26 percent of all business taxpayers claimed that they were assessed penalties on employment returns. Of taxpayers receiving penalty assessments, 64 percent claimed to have had erroneous assessments, and of these, 89 percent said that they protested. The taxpayers surveyed claimed that IRS agreed that the assessment was erroneous in 66 percent of these protests. Taxpayers claimed that in 35 percent of erroneously issued penalty assessments, 3 or more notices were sent by the IRS after the taxpayer protested (even when the IRS agreed that the assessment was erroneous). In 64 percent of erroneous issuances, respondents claimed that proof was offered which clearly indicated an IRS or bank error.

The survey produced a number of recommendations for procedural changes in order to ease the burden of the collection process. These are summarized as follows:

* Upon receipt of a protest from the taxpayer, the IRS should place a hold on further action until the issue is resolved.

* The IRS should establish a quality control program aimed at reducing errors made by banks in processing Federal Tax Deposit monies and by IRS Service Centers in processing returns.

* The IRS should review and improve the clarity of notices and letters.

* In the penalty notice, the IRS should provide the name of a specific contact person who can resolve the dispute on first contact or by reply in a short period of time.

* The IRS should provide a sufficient number of toll free telephone lines (and personnel) so that the taxpayer does not have to wait long or get many busy signals.

* The IRS should issue a warning, instead of a penalty, if the taxpayer has not had a penalty asserted for the same reason in the last 3 years.

* The IRS should be more speedy and thorough in replying to taxpayers. Better trained and supervised personnel are needed in units that handle correspondence from taxpayers.

* The IRS should provide non-technical taxpayer educational material on employment returns and Federal Tax Deposit requirements.

* An administrative tolerance of several days should be used in determining whether a Federal Tax Deposit was made in a timely fashion.

* Legislation should be enacted requiring the IRS to pay taxpayers for expenses incurred in obtaining an abatement of an erroneously assessed penalty.

Because the survey was based on a sample taken from a list which did not contain businesses started under three years ago, the data represent only businesses that were active in 1984 and which remained in business through mid-1987.

BROWN
ASSOCIATES INC.

TABLE OF CONTENTS

SUMMARY i

TABLE OF CONTENTS iii

I INTRODUCTION 1

II THE SURVEY 4

- QUESTIONNAIRE AND CODING 6
- SAMPLE SELECTION 10
- SURVEY EXECUTION 10
- LIMITATIONS OF THE DATA 12
- TABULAR DATA FROM THE SURVEY 13
- ADDITIONAL OBSERVATIONS 17

III RECOMMENDATIONS 17

IV DISCUSSION OF RECOMMENDATIONS 19

APPENDIX:

- FORM 941
- FORM 940
- EXCERPTS FROM CIRCULAR E

I INTRODUCTION

This study was conducted in connection with the U. S. Small Business Administration's responsibility under PL 94-305 to represent the interests of small business before Congress and Federal agencies. The specific objectives of the study were:

(a) to examine the reasons for the large number of erroneous penalty assessments on small business employment tax returns.

(b) to determine the extent to which small business taxpayers elect to pay erroneous penalties instead of attempting to have the penalty removed.

(c) to suggest ways to ease the burden of erroneous assessments on small firms through revision of IRS procedures and/or business educational efforts.

Penalty assessments may be imposed for:

(1) failure to timely file a required tax return Form 941 - Employer's Quarterly Federal Tax Return or, Form 940 - Employer's Annual Federal Unemployment (FUTA) Tax Return. In this study, information returns associated with employment (such as Form W2) are not considered.

(2) failure to pay all taxes due with the filing of the return.

(3) non-compliance with certain requirements of the Federal Tax Deposit (FTD) system, for example, failing to make the required deposits when they are due or making them in insufficient amount or sending the deposits to a place other than the authorized depository (generally a bank that is a member of the Federal Reserve System).

Employment tax returns (particularly the Form 941) are extremely important in collection of revenue needed to run the federal government. Approximately 3/4 of total federal revenues are collected in conjunction with Form 941 and the related deposits made through the Federal Tax Deposit (FTD) system. These revenues include the amounts withheld from employees' wages for income and social security taxes as well as employers' share of the social security taxes. Employers are required to withhold from the employees' wages an amount specified in Circular E (Employer's Tax Guide). Income taxes withheld, along with the employer's and employees' portions of social security taxes, must be deposited to the Treasury Department's account at a bank within the time specified by Circular E. The Federal Tax Deposit form, Form 941 and relevant portions of Circular E are shown in the appendix.

The most accurate data available on penalty assessments for employment returns and abatement of such penalties is found in the IRS Commissioner's Annual Report (Table 14, 'Civil Penalties Assessed and Abated'). These data have been summarized for recent years in Table A. A penalty is abated when the penalty and any interest which may have resulted from the penalty is removed. The law authorizes the IRS to abate a penalty when the taxpayer can show that the offense for which it was imposed resulted from a "reasonable cause".

By far, the most frequent cause for abating a penalty on an employment return is that the IRS assessed the penalty in error. An erroneous penalty can be abated only if the taxpayer "protests" (i.e. complains that it is erroneous and should be removed). Instances in which the taxpayer elected to pay the penalty without protesting are not, of course, reflected in the number of abatements shown in Table A.

Penalties assessed for untimely deposits have declined dramatically in the last two years, from over 5 million to under 1 million. However, the percent of assessments issued erroneously has doubled, from 19 to 36 percent. Erroneous penalty assessments can result from taxpayer errors in completing the FTD deposit slip, from bank errors, from Federal Reserve District errors, or from IRS Service Center errors in processing the return or the data from the banking system.

The number of penalties assessed for delinquent filing of returns has not increased significantly over the past decade but the percentage of penalties abated has increased four fold, from 6 to 24 percent. Almost half of this increase took place in 1986 alone. These are clearly errors which involve only the IRS Service Centers since the banking system is not involved. Such penalties are correctly assessed when a return is filed later than the due date.

Penalties assessed for Failure to Pay have been steadily increasing for the past decade, from 2.3 million in 1978 to 5.2 million in 1986. Over the same period, the percentage of these assessments abated has nearly doubled, from 13 to 23 percent. The result is a quadrupling of abated penalty assessments for Failure to Pay. IRS related errors in issuing these assessments are clearly difficulties with the IRS Service Centers.

The 2.2 million penalty assessments challanged by taxpayers in 1986 represent a considerable expense and annoyance to the small business owners who receive them. They also pose a burden to the IRS, which is not prepared to handle the large volume of taxpayers' protests. Attempts by the taxpayers to settle their problems over the telephone is an exercise in frustration. Correspondence takes several months and sometimes much longer. In the meantime, the IRS continues to send notices of payment due. Sometimes the IRS threatens to seize assets even after the taxpayer has successfully communicated the nature of the problem with the IRS.

It is not possible to pinpoint the exact reasons for errors at the IRS Service Centers from the survey -- only a study of Service Center operations can provide this information. It is possible, however, to make recommendations for a reduction of errors and a more speedy resolution of erroneous penalties.

Table A

EMPLOYMENT TAX RETURNS
PERCENTAGE OF PENALTY ASSESSMENTS WHICH HAVE BEEN ABATED

Year	Untimely Deposit		Delinquent Filing		Failure to Pay		Total of Penalty	
	Assessed (1000)	Percent Abated	Assessed (1000)	Percent Abated	Assessed (1000)	Percent Abated	Assessed (1000)	Percent Abated
1986	985	36	2,614	24	5,182	23	8,781	25
1985	2,445	38	2,393	14	4,408	33	9,247	29
1984	5,159	19	2,486	11	4,257	27	11,902	20
1983	4,454	19	2,251	11	3,801	23	10,505	19
1982	4,649	14	2,280	9	3,417	19	10,345	15
1981	2,772	11	2,304	7	3,020	16	8,096	12
1980	3,013	8	2,194	7	2,633	17	7,839	11
1979	2,620	8	2,248	6	2,495	15	7,364	10
1978	2,051	8	2,080	6	2,371	13	6,502	9

II THE SURVEY

This survey was conducted by mailing approximately 8,500 questionnaires to businesses selected from the Master Establishment List (MEL) maintained by the Small Business Administration (see pages 6 - 17 for information on the questionnaire, coding for tabulations, sample design, survey execution, data limitations, and final tabulations).

Nationally, 26 percent of taxpayers claimed to have had penalties imposed and of these, 64 percent reported penalties which were erroneous (Table 1). Of those reporting erroneous penalties, 89 percent reportedly protested the penalty and for 66 percent of these it was claimed that the IRS agreed that it was erroneous.

Differences in responses from one region to another were small in the penalties imposed, but fairly large, from 56 to 77 percent, in the percentage of penalties which were imposed erroneously. There is also a large variation reported in the percentage of protested penalties which the IRS agreed were in error (ranging from 59 to 74 percent).

Penalty assessments relating to Form 940 were claimed to be in error for 68 percent of recipients (Table 2). Most taxpayers (62 percent) received Form 941 erroneous penalty assessments for only 1 quarter, although 11 percent received penalty assessments for two quarters and 13 percent for three quarters.

Further, respondents claimed that even when the IRS agreed that the penalty was imposed erroneously it was not unusual for three or more notices to be sent by the IRS (Table 3). The receipt of these additional notices, after the taxpayer has followed procedures to have the issue resolved (and even when the IRS has agreed that the assessment is erroneous), causes considerable irritation, confusion and expense for the small business owners. Generally, small businesses with 50 or more employees protested if the penalty was wrongly imposed but many of the smallest companies did not protest even when they thought the IRS was in error.

Taxpayers with a very small number of employees (less than four) had a considerably smaller percentage of penalties imposed (Table 4). This may indicate that fewer problems result from monthly payments of Form 941 tax liabilities instead of more frequent deposits which are required because the undeposited tax liability has exceeded the upper threshold amount of $3000 (for the current deposit rules, see page 9 of "Circular E" which is reproduced in the appendix). In many cases, a business might be making deposits as frequently as eight times per month. This is an argument for raising the upper threshold of the Federal Tax Deposit system.

In 64 percent of the cases in which the IRS agreed that the penalty assessment was erroneous, the taxpayers reportedly offered clear and convincing evidence (such as cancelled checks) to support their claim (Table 5). In an additional 3 percent of cases, the IRS reportedly accepted the taxpayer's claim of "reasonable cause". In still other cases there was "reasonable cause" which the taxpayer did not claim because he or she did not know if it would be accepted.

The percentage of erroneous penalties reported by industry is given on Table 6. As indicated on that table, the construction business (which had 9 percent of all taxpayers in the survey) had 41 percent of taxpayers with penalties (compared with 26 percent overall), but only 46 percent of these taxpayers had erroneous penalties (compared with 64 percent overall).

One of the most valuable results of the survey was the employers' suggestions for easing the paperwork and administrative burden on small businesses (Table 7). These suggestions form the basis for many of the recommendations made in this study. For these recommendations, see pages 17 to 22.

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COMPLETION OF THIS
FORM IS VOLUNTARY

OMB Clearance No. 3245-0224
Expires on 1/31/88

ERRONEOUS PENALTIES ASSESSED BY IRS ASSOCIATED WITH PAYROLL TAXES

1. Did your firm have any employees during 1986?
   ☐ YES ☐ NO (go to question 17)

2. Was there a penalty imposed by IRS for 1986 Employer's Federal Tax Return (Form 941) or for a 1985 Annual Unemployment (FUTA) Form 940 return?
   ☐ YES ☐ NO (go to question 15)

3. For which return(s) was a penalty imposed?
   ☐ Form 940 1985 ☐ 941 1st Q 1986 ☐ 941 2nd Q 1986 ☐ 941 3rd Q 1986

4. Were any of these penalties INCORRECTLY imposed?
   ☐ YES ☐ NO (go to question 15)

5. For which return was a penalty imposed in error?
   ☐ 940 1985 ☐ 941 1st Q 1986 ☐ 941 2nd Q 1986 ☐ 941 3rd Q 1986

Answer questions 6 through 14 only with reference to the last return checked on question 5. If there was more than one penalty imposed, answer these questions with respect to penalties incorrectly imposed.

---

6. Did you protest to IRS that penalty should not have been imposed?
   ☐ YES ☐ NO (go to question 9)

7. Did IRS agree that penalty was imposed in error?
   ☐ YES ☐ NO (state reason of IRS for not agreeing) ____________________

8. What proof did you submit that the penalty was in error?
   ____
   ____

   After supplying the required proof, how many additional IRS notices did you receive on this same assessment?
   ____________ (go to question 11)

9. Why did you not protest (check all that apply)?
   ☐ Advice of accountant ☐ Did not want hassle
   ☐ Amount too small to warrant time and/or cost to protest
   ☐ Other, specify ____________________

10. Even though you did not protest, what proof did you have that the penalty was imposed in error?
    ____
    ____

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11. Reasons(s) given by IRS for the penalty? (check all applicable)
    - ☐ Return was filed late (answer question 12)
    - ☐ Federal Tax Deposits not made timely (answer question 13)
    - ☐ Timely depost made to IRS Dist. Office (answer question 14)
    - ☐ Failure to pay tax due with filed return (answer question 15)
    - ☐ Other (specify)
      (answer question 15) ______________________________

12. If a penalty was imposed because of late filing, was the return:
    - ☐ Mailed to IRS Service Center on or before due date
    - ☐ Mailed to IRS District on or before due date
    - ☐ Given to Revenue Officer on or before due date
    - ☐ Filed late but with reasonable cause: State reason:
      ____

13. If deposit was made timely to a depository bank was it made:
    ☐ By Mail ☐ In Person

14. If deposit was to IRS Distr. Office or Service Center, the reason was:
    - ☐ No deposit forms and no Employer Identification No. (EIN)
    - ☐ Had EIN but ran out of deposit forms
      - ☐ Delayed in requesting more deposit forms
      - ☐ IRS delayed in sending deposit forms:
        took ______ weeks
    - ☐ Other, specify ______________________________

---

15. Does an accountant or payroll service prepare:

Prepare your tax return	Inform you when a Tax Deposit is due
☐ YES ☐ NO	☐ YES ☐ NO

16. What was your total number of employees during the first quarter of 1986? ____________

17. What type of business do you conduct? If retail state kind.
    ____

18. Is your business conducted from more then one location?
    ☐ NO ☐ YES, How Many ____________

19. With respect to the administration of the payroll tax laws (but not with respect to the law itself) give suggestions to ease the burden of IRS procedures on small business.
    ____
    ____
    ____
    ____
    ____
    ____
    ____
    ____

QUESTIONNAIRE CODING

Several of the questions are open ended and require coding for tabulation. The coding used is given below by question number.

Question #7
2 = No reason
3 = Not a reasonable cause
4 = No error
8 = Not settled yet
9 = No response

Question #8 -- first part
1 = Cancelled check
2 = Employment record
3 = Deposit card with tellers initials & time
4 = Copy of tax return
5 = Exception under Rule #4
6 = Letter of explaination
7 = 1 and 4
8 = 1 and 2
9 = 1 and 3
A = Penalty warranted but not calculated correctly
B = 1 and 6
C = Other
E = Reasonable cause
F = No proof
X = None given

Question #8 -- second part
The number given in the questionnaire or if not a number :
4 = several
8 = many

Question #9
1 = Advice of accountant
2 = Did not want hassle
3 = Amount too small to warrant time
A = 1 and 2
B = 1 and 3
C = 2 and 3
D = Protested to bank

Question #11
1 = None
2 = Credited wrong account
3 = Failure to file return
4 = Reported wrong tax amount
5 = Check returned - NSF
6 = Failed to make contribution to state for unemployment insurance
7 = Taxpayer used incorrect EIN
8 = Mixed deposits of different quarters

Question #12
1 = Change of staff
2 = On vacation
3 = Death of a relative
4 = No deposit slips
5 = Accident
9 = Unknown

Question #14
1 = No deposit form or EIN
2 = Ran out of deposit forms
3 = The IRS delayed in sending forms

Question #17
01 = Retail
02 = Wholesale
03 = Manufacturing
04 = Construction (incl. residential & contractor)
05 = Transportation (incl. auto repair & service)
06 = Professional personal services (doctor, dentist, optometrist, funeral home, hospital, personal care home, veterinarian)
07 = Business services (CPA,legal, insurance, advertising, data entry, consultant, messenger, manufacturer's rep. typesetter, architect, cleaning, printing, software
08 = Financial
09 = Non profit
10 = Real Estate (incl. motel, apt., warehouse, elderly housing, property management, sales)
11 = Food service (incl. fast food & restaurants)
12 = Entertainment (incl. camp, movie, golf, club, radio station)
13 = Miscellaneous
14 = Education
15 = Farming
16 = Other personal services (heating & air conditioning, barber, plumber, travel agent, dry cleaning, parking, car wash, TV repair, gas station, diet consultant, garbage collection, investment advisor, child care, landscape maintainance)
99 = Unknown

Question #19
A = Reduce bank errors in transmitting FTD monies
B = Less frequent deposits
C = Less paperwork and/or forms
D = Less changing of tax forms
E = Should not have penalty for few days late or first time errors
F = Need more expeditious replies or action by the IRS
G = Change 3 day deposit rule and 1/8 month to something more easy to understand
H = Need more competent IRS personnel
I = Need omnibudsman to keep the IRS off our back
J = Need to clarify instructions, reason for penalty, letters
K = Too much paperwork needed for proof
L = Response to taxpayer replies is not expeditious or thorough
M = The IRS should assign a specific person to handle case and answer questions. Give direct contact toll free number which is not always busy.
O = The IRS should pay attention to "final out"
P = Employees should pay their own payroll tax instead of employer doing it
Q = Attitude of the IRS people is arrogant and/or intimidating
R = There should not be a penalty on errors made by the IRS
S = Taxpayer should be compensated for expenses caused by IRS errors
T = Do not penalize honest errors
U = Need to educate businessmen re forms, deposit rules and/or reasonable cause
V = Allow additional reporting & deposit time on payroll taxes related to third party paid benefits
W = Unknown, not decipherable
Z = Not acceptable suggestion such as don't penalize small business or let taxpayer pay later, or just complaining, or curb the power of the IRS
1 = Verify quarter indicated is correct before sending penalty on correct quarter and refund on incorrect quarter
2 = Allow 1 or 2 employees "without all of this mess"
3 = Other

SAMPLE SELECTION

The only file suitable to sample for this study was the Small Business Administration Master Establishment List[1] (MEL). This file consists of two segments; 5.5 million names on the Dun and Bradstreet (DAB) segment, and 3.37 million on the Market Data Retrieval (MDR) segment. The DAB segment of the MEL should have been sampled so as to give a zero chance of selection to branches of multi-establishment organizations. This was inadvertently not done and was not discovered until after the first mailing. The data file was corrected by deleting all selected branch establishments from the returned questionnaires and from the sample control file for further mailings. Similarly, religious organizations, governmental units and large companies were deleted from the sample because the study was targeting small business.

There were two stages to the sample selection process. In the first stage, approximately 100,000 establishments were selected from the DAB segment (a rate of 1 out of 50) and approximately 10,000 establishments were selected from the MDR segment (a rate of 3 out of 1000). The selection method was the fifth and sixth digits of the telephone number for DAB and fourth, fifth and sixth digits for MDR. The second stage selection assured a representative geographic composition. The DAB segment file was ordered by ZIP code and ten sub-samples were selected by choosing every one hundredth entry after a random start. Also, the MDR segment file was ordered by ZIP code and two sub-samples were selected by taking every fourteenth entry after a random start.

SURVEY EXECUTION

Four mailings of the questionnaire were made with the following results:

Mailing	Returned by P.O.	Deleted *	Completed **
1	1836	1216	453
2	327		443
3	370		346
4	156		200
Total	2689	1216	1442

* 693 sample members were deleted because they were branch establishments and 523 were deleted government units, religous organizations, or large companies

** 163 of the completed returns indicated no employees 94 indicated that they were government, large company, religious, out of business, or refused to fill out the form. Also 6 were eliminated as duplicates.

1/ For details regarding the composition of the list see "Final Report on the Development of the Master Establishment List" March 1986 by Social and Scientific Systems, Inc. Available from the Small Business Administration.

Of the 1,442 reponses received, 257 were deleted. This left 1,185 useable responses out of an initial mailing of 9,966. The apparent low response rate is attributable to defects of the list from which the sample was selected (as is indicated by the following):

2689	Returned by the Post Office as undeliverable
1216	Deleted prior to mailing as branches, governments, large companies and religious organizations.
163	Responses saying no employees
94	Responses deleted as government, large companies and religious organizations
1344	Out-of-business segment of non-respondents not returned by the Post Office (as estimated by the telephone survey)
1008	Non-responses having no employees (as estimated by the telephone survey)
6514	Total

Thus the total number of businesses on the list which is comparable to the number of businesses responding is 3452 and the response rate on this basis is 34 percent.

A control listing of the sample by replicate was maintained. Although the respondent was not asked for his or her identity, it was usually possible to identify respondents from the type of business, the postmark and the replicate (which was coded by our return Post Office box). Also the respondents frequently identified themselves. Thus it was possible, in many cases, to avoid sending another request when a response was received. Additional requests were, of course, not sent in the case of returns by the Post Office. Since it was not always possible to identify the respondent, our cover letter for the second and subsequent mailing requested that a questionnaire not be returned if one had previously been returned. This request was not always followed. Therefore, returned questionnaires were checked for duplicates which were deleted if found.

Telephone follow-up of one replicate of the sample was conducted. For this replicate there were 400 members who did not respond to any of the four mailings. The results of this survey were as follows:

28%	out of business
21%	had no employees
15%	refused information
24%	said that they had no penalties
3%	said they had penalties (12 respondents) but only 2 said that the penalties were erroneous
7%	resulted in no contact with the persons who could provide the information (3 calls were made)
1%	were deleted as government, branches or large companies

Weights were determined for the DAB segment as follows: (population no. of companies) / (non-branch sample elements) or (5507000 - 529000) / (9966 - 693) = 537.
The MDR segment contained branch establishments which were not identified as such. Therefore, the initial weight was divided by the number of places at which business was conducted (question #18). The initial weight for the MDR segment was determined as follows:
(population establishments) / (sample establishments) or (3370000 / 1832) = 1841.

LIMITATIONS OF THE DATA

The principal limitation of the data is that it reflects only small businesses which are and have been in business for at least 2 1/2 years. This represents a major noncomparability with IRS data. Businesses which started after 1984 are not on the list from which the sample was drawn (the MEL). Such new firms might be expected to have significant problems because they are unfamiliar with the intricacies of the payroll tax system. Businesses which ceased operations since 1984 and which were on the MEL are also not represented.

In addition to businesses, certain other organizations are liable for the payment of withholding and FICA taxes: nonprofit organizations, religious organizations, governmental units, etc. They have been deleted from the mailing. Large organizations (over 500 employees) have also been deleted. About 12 percent of organizations on the list had no employees. They are not reflected in IRS data since they are not liable for employment taxes.

In making estimates from a sample, it is frequently assumed that the non-respondent group is similar in characteristics to the group which responded. We do not believe that such an assertion for this survey would be valid. Telephone follow-up of non-response was done for one replicate of the DAB segment of the sample. The results of this effort are given in the section "Survey Plan and Execution". Because so much of the list population is not reflected in returned questionnaires (66 percent) and because we believe that the character of the IRS population is somewhat different than the population represented by the questionnaire, we have presented data in percentage form rather than as level estimates of the population.

Another major limitation is that the data on erroneous penalties do not apply to all penalties claimed to be erroneous. Such data were requested only for the last of the first 3 quarters of 1986, or if none of these were claimed to involve an erroneous penalty, the 1985 Form 940. This was done in order to keep the questionnaire simple. Thus data on the reason for the penalty involves only those penalties which were claimed to be erroneous and favors such penalties for Form 941. The Form 940 specified on the questionnaire was for the 1985 year; the fourth quarter 1986 Form 941 was not included because of the timing of the survey. This is another source of non-comparability with the IRS report.

As might be expected, the tabulated sample has a greater proportion of larger firms than the list from which the sample was drawn. The data are as follows:

Employee Size	Percent on the Population List	Percent in the Sample
1 - 4	53	35
5 - 9	23	20
10 - 19	12	16
20 - 49	8	13
50 - 99	3	5
over 99	2	4

The difference reflects the fact that a larger proportion of smaller companies has gone out of business in the past three years, and that larger firms have better response rates.

TABLE 1

PENALTY ASSESSMENTS REPORTED BY IRS REGION

IRS Region	Percentage of Taxpayers with Penalty Imposed	Percentage of Taxpayers with Penalty Having Penalty in Error	Percentage of Taxpayers with Erroneous Penalty Who Protested	Percentage of Taxpayers for Which IRS Agreed Penalty Was in Error
Southeast	24	61	95	74
Western	29	69	95	68
Mid-Atlantic	25	57	88	76
MidWest	29	77	94	59
Southwest	21	60	82	72
N. Atlantic	28	56	80	60
Central	28	61	85	66
All Regions	26	64	89	66

TABLE 2

PERCENTAGE OF TAXPAYERS CLAIMING PENALTY ASSESSMENTS BY FORM TYPE

FORM	Percentage of Taxpayers Who Had Penalty Assessments	Percentage of Erroneous Penalties for Taxpayers with Penalties
940 (1985)	29	68
941 (1986)		
1st Quarter	35	52
2nd Quarter	41	68
3rd Quarter	46	47
3 Quarters	13	42
2 Quarters	11	32
1 Quarter only	62	68

Table 3

NUMBER OF NOTICES CLAIMED TO HAVE BEEN RECEIVED AFTER PROTEST

Number of Penalty Notices Erroneously Sent	Percentage of Penalties that IRS Agreed were Erroneous	Percentage of Total Erroneously Issued Assessments
Zero	63	30
1	84	11
2	73	25
3	82	16
4 or several	20	6
5	67	3
6	100	2
7	100	1
Many	25	7

Note: This tabulations includes only one protested erroneous assessment per taxpayer regardless of the number of such assessments which were imposed

Table 4

PENALTIES REPORTED ASSESSED BY EMPLOYEE SIZE

Number of Employees	Percent of T/P with Penalty Imposed	Percentage of of T/P with Penalty Having Penalty in Error	Percentage of T/P with Erroneous Penalty Who Protested	Percentage of T/P For Which IRS Agreed Penalty was in Error
1	13	62	89	75
2	21	63	81	68
3	18	49	90	78
4	25	48	83	60
5 - 9	28	65	95	69
10 - 14	30	69	96	71
15 - 24	27	53	88	71
25 - 49	20	60	67	38
50 - 74	48	74	100	86
75 - 99	39	57	100	75
over 99	29	73	91	70
unknown	36	80	79	41
All Taxpayers	26	64	89	66

Note: T/P = Taxpayer

Table 5

PROOF CLAIMED TO HAVE BEEN OFFERED THAT THE PENALTY WAS ERRONEOUS

Type of Proof Offered	Percentage of Taxpayers Who Claimed Erroneous Penalties
Cancelled Check *	48
Employment Records	5
FTD Slip	8
Copy of Return	3
Letter of Explanation	13
Reasonable Cause	3
Other Reasons	4
No Reason Given	15

* Includes 15% which offered both cancelled check and one of the next four reasons.

Table 6

ERRONEOUS PENALTIES CLAIMED BY INDUSTRY

Industry	Percentage of All Taxpayers	Percentage of Taxpayers with Penalties	Taxpayers With Erroneous Penalties as a Percentage of Taxpayers with Penalties
Retail	22	22	62
Wholesale	6	22	54
Manufactureing	8	41	61
Construction	9	41	46
Transportation	2	38	76
Agriculture	2	12	67
Financial	2	13	100
Real Estate	4	22	70
Education	1	0	0
Professional Service	11	18	60
Other Personal Service	10	28	63
Food Service	3	28	60
Entertainment	1	0	0
Business Services	12	30	69
Non-Profit	2	10	100
Miscellaneous	3	23	86
Unknown	2	66	100

Table 7

SUGGESTIONS BY RESPONDENTS

Suggestion	Percentage of all Suggestions
More Expeditious or Thorough Action or Reply by IRS	19
Clarify Instructions, Letters & Reasons for Penalty	17
Assign Specific Knowledgeable Person & Toll Free No.	13
More Competent IRS Personnel	7
Less Paperwork and/or Forms	6
Less Frequent FTD	5
Attitude of IRS Personnel is Arrogent or Intimidating	3
Change 1/8 Month -- 3 Day Rule	3
No Penalty for Few Days Late or 1st Time Error	3
Need to Educate Businesses re Forms & FTD Rules	2
Reduce Banking Errors	2
Don't Penalize Honest Errors	1
Verify that the Checked Quarter is Correct	1
Unknown	1
Not Acceptable Suggestion	17
Other	6

ADDITIONAL OBSERVATIONS

Penalties for late FTD deposits might result from mailing the deposit to the bank instead of making it in person. Responses to question #13 indicated that 82 percent of the taxpayers who had a penalty for untimely FTD had made the payment to the bank "in person". A few of the respondents blamed the banks for not crediting their payments immediately in order to get interest-free use of the funds. We have no information as to whether there is any validity to this claim. IRS can make such a determination by a comparison of the dates on proofs submitted with the date on which the bank gave credit for the deposit. If the bank has been using a "float time", then obviously the taxpayer should not be penalized. IRS has the responsibility to either stop this practice or to allow a tolerance before imposing a penalty for untimely deposit.

Question #14 was inserted to determine the prevalence of penalty assessments because make deposits are made to a district office instead of to a depository bank. The question also dealt with difficulties in obtaining deposit forms. There is no evidence from this survey that penalty assessments for deposits to the district office are a problem. The sample, however, does not contain businesses that began in the past three years, and situation may be different for new businesses. There were some complaints about the length of time it took to get deposit forms from IRS.

Tabulation of question #15 indicates that the use of an accountant (or payroll service) was not related to the issuance of penalty assessments. For those taxpayers with penalty assessments, 58 percent used an accountant or payroll service whereas 62 percent of all taxpayers used such a service.

III RECOMMENDATIONS

In the past several decades, costs have been rising faster than the IRS budget, putting pressure on the means to maintain the high quality of service to which the IRS aspires. In the zeal to produce the highest revenue for the resources provided, the IRS has not given due cognizance (in our view) to the cost its procedures have imposed on the taxpayer. The goodwill and respect of the taxpayer is essential to effective tax administration. This goodwill should not be jeopardized by a short-sighted policy to save the money that would otherwise be spent ensuring that the taxpayer is treated fairly. It is, therefore, urged that cost considerations not be cited as the reason for not instituting any of the recommendations given below.

ADMINISTRATIVE

(1) Upon receipt of a protest from the taxpayer, the IRS should place a hold on further action, such as sending more notices or allowing the account to proceed to delinquent status, until the issue is resolved.

(2) The IRS should establish a quality control program aimed at reducing the errors made by the Federal Reserve Banks in processing FTD monies and by the IRS Service Centers with respect to returns processing.

(3) The IRS should review its notices and letters to improve clarity. We suggest that the IRS conduct studies similar to the focus group studies which have been conducted in recent years for the income tax returns.

(4) The IRS should specify in the notice of penalty a specific person to contact about the problem. This person should be able to resolve the issue over the phone either on the first contact or by prompt reply.

(5) The IRS should provide a sufficient number of toll-free telephone lines so the taxpayer does not have to wait a long time on the line or get many busy signals.

(6) The IRS should issue a warning statement instead of a penalty if the taxpayer has not had a penalty asserted for the same reason within the last three years.

(7) The IRS should be more speedy and thorough in its replies to taxpayers. Better trained and supervised personnel are needed in the units that handle replies from taxpayers.

(8) The IRS should provide taxpayer educational material relative to employment returns and FTD requirements. This material should be in non-technical language and should not include material which is unlikely to apply to small businesses.

(9) An administrative tolerance of several days should be used in determining whether a Federal Tax Deposit was made in a timely fashion.

LEGISLATIVE

(1) Legislation should be enacted requiring the IRS to pay taxpayers for expenses which they have incurred in obtaining an abatement of penalties (and interest when appropriate) which resulted from errors of the IRS.

IV DISCUSSION OF RECOMMENDATIONS

The preceeding proposals are suggested by the data tabulated from the survey questionnaire, especially the part that asks for respondent recommendations.

(1) Table 3 shows that additional notices are usually sent by the IRS after the taxpayer has protested that the penalty was erroneous. Two or three notices were typical, although as many as six or seven had been sent. Furthermore, such notices were sent whether or not the IRS agreed that the penalty was erroneously assessed. The practice of IRS in continuing to send notices after the problem is supposed to be resolved or is in the process of being resolved is source of both confusion and frustration to the taxpayer. Clearly notices should not be sent in cases where the IRS agrees an error has been made. Nor should they be sent during the time that the IRS is investigating whether the penalty should be abated. When the IRS wishes to assure that premature contact does not take place with a taxpayer because there is a possibility of criminal prosecution, a hold procedure is used. As long as this hold stays in the computer, no notices or other action is issued. When the hold is removed, normal computer procedures are followed. It should be feasible to adopt a similar procedure with respect to the specific tax module which is involved in the protested penalty assessment.

(2) While respondents claimed that some of the penalty assessments were abated for "reasonable cause" (such as illness or death of a bookkeeper), the vast majority of erroneous penalties were reported to be the result of errors made in processing the tax information. That these errors result from data processing is evidenced by the large number of times that IRS reportedly agreed that the penalties were erroneous (Table 4) and the type of proof reportedly offered by the taxpayer (Table 5). Such errors may be reduced through a vigorous quality control program. Some aspects of this program will involve only the IRS Service Centers and some will involve the data processing operations of the Federal Reserve System. We recommend that the quality control program be coordinated in the National Office and that excessive errors pinpointed by the tabulations be referred to the quality control supervisor of the appropriate Service Center. Similarly, excessive errors of specific Federal Reserve Districts should be referred to the appropriate office of the Federal Reserve District involved.

Errors giving rise to a penalty for insufficient or late Federal Tax Deposits can result from processing errors at an IRS Service Center, errors at the bank in which the deposits were made, or from errors of processing data to a computer tape by the relavant Federal Reserve District. The IRS Business Masterfile contains information that will enable a relatively inexpensive quality control program, and we recommend that the IRS utilize this data for that purpose. The masterfile record contains the reason for the penalty and whether it was abated. The ZIP code of the taxpayer will also identify both the IRS Service Center and the Federal Reserve District involved. The percent of assessments for late or insufficient tax deposits for Form 941 that are abated should be tabulated weekly by both the IRS Service Centers and the Federal Reserve Districts. Penalties imposed for reasons other than late or insufficient tax deposits should also be tabulated by the IRS Service Center and a similar quality control activity should be pursued.

(3) The most frequent suggestion by respondents was for the IRS to improve the clarity of IRS instructions, notices and letters. A frequent comment was that the taxpayer could not determine the reason for the penalty. This comment was made by otherwise sophisticated business persons such as doctors, dentists and lawyers. This has been a problem of long standing with the IRS. We suggest that IRS conduct studies on the clarity of these notices and letters similar to the "focus group" studies conducted in recent years for income tax returns. Taxpayers who had made many deposits, complained that without a listing of dates and amounts of deposits received by the IRS they could not tell which deposit was in question. Consequently, they were forced to do an excessive amount of work to resolve the issue.

(4) & (5) The second most frequently made suggestion was that the IRS specify in the penalty notice a specific person to contact about the problem for which the penalty was imposed. That person should be able to resolve the issue telephonically on the first contact or by a prompt written reply. Contact should be by toll-free number and a sufficient number of phone lines should be provided to expedite the resolution of problems. The delays and inability to reach IRS offices over the telephone have engendered many caustic comments, and do much to erode taxpayer goodwill. The IRS monitors phone calls to assure proper conduct by its personnel. It should also monitor the waiting period and the number of busy signals given the callers in order to assure that a sufficient number of lines and personnel are provided. These suggestions are made from the perspective of providing good service with the least burden on the small business taxpayer. Current IRS procedures emphasize efficiency from a data operations standpoint. The IRS would prefer to handle incoming correspondence rather than phone queries, but this is not as convenient for the small business taxpayer. Similarly, from the IRS perspective it is easier not to assign particular cases to particular IRS personnel, but this practice results in considerably more expenditure of time forced on the taxpayer. The IRS needs to achieve a better balance between service to the taxpayer and its budgetary considerations.

(6) Most small business taxpayers are not knowledgeable in tax rules and regulations. Most cannot afford the continuing advice of an accountant and are too busy conducting their business to become experts in interpreting confusing forms and instructions. Several respondents complained that it was not justice that they be penalized because of failure to deposit within three banking days when this was the first time that they were required to do so. They said that they paid the penalty and did not realize that they could escape the penalty because of the "exception to rule 4", which is printed in the instructions on the back of the Form 941. Others have complained that they try to follow the rules but that they sometimes face a situation that unavoidably makes them late with a return or a deposit (such as their own illness or that of a secretary). Apparently they are unaware that the penalty can be abated for reasonable cause or they do not know that their circumstances may constitute a "reasonable cause".

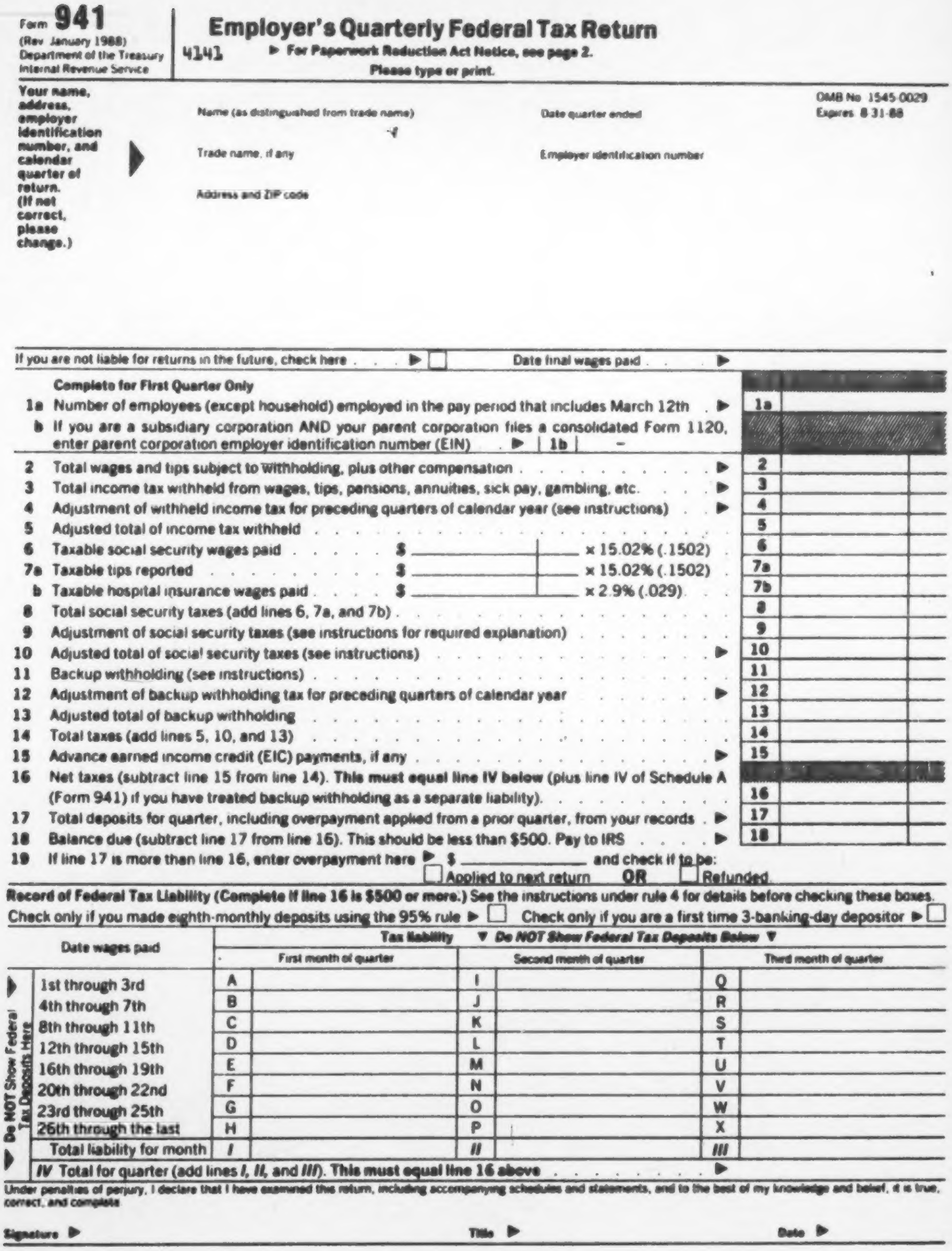
With regard to the Form 940, several of the respondents indicated that they were completely confused by the deposit requirements and that they settled for paying the penalty when called upon to do so. Comments such as these indicate a need to simplify the rules, educate the taxpayer, and be more lenient on first-time failures to follow the rules.

The IRS should issue a warning statement instead of a penalty if the taxpayer has not been penalized for the same reason in the last three years. This is not meant to be soft on negligent taxpayers, but to take into account the fact that small taxpayers are not so knowledgeable of the rules and are more subject to unforeseen events such as illness of the person doing the payroll, etc. The purpose of the penalty is to encourage compliance and it should not be asserted as a punishment for ignorance or inadvertence. There are many cases of penalties being excused for "reasonable cause", now authorized by law. This should be broadened to encompass instances where the taxpayer has made a first-time error. This would be equivalent to an abatement for "reasonable cause" without the expense to the IRS and the taxpayer. In addition to reducing expenses, such a procedure would provide the same education for the future as would the assertion of the penalty. It would also bring much needed goodwill to the IRS. In many cases, the penalty would under present rules be abated either under the exception to rule 4 or for "reasonable cause" if the taxpayer knew of such provisions. We believe that the IRS now has the authority to institute this procedure. If the IRS believes it needs to seek statutory authority, we urge it to do so.

(7) Respondents frequently commented that IRS replies or actions with regard to taxpayer contacts should be more expeditious and thorough. Several months to reply was common, and in one case, six months was claimed. There was understandable annoyance with the Service taking so long to reply while demanding a reply to its correspondence within 10 days. There are many comments to the effect that much better trained or more competent personnel are needed in the units which handle replies to taxpayers. Situations cited included several items of correspondence before a correct reaction was obtained even though the correct reaction should have been elicited by the first letter. Many responses were quite caustic with respect to the quality of IRS personnel. We recommend that the Service Center Quality Control Staff develop a program addressing both the quality and timeliness of responses. If the problem is shortage of staff, we recommend that the IRS allocate more of its resources to this area even if it means that manpower must be taken from that allocated to compliance activities, such as audit.

(8) We recommend that the IRS provide educational material on Form 940 and Form 941, including the Federal Tax Deposit requirements. This material should be in non-technical language and should not include material unlikely to apply to small businesses. Items should be covered by example. Many illustrations of what is acceptable as "reasonable cause" for abating a penalty should be included and there should be a comprehensive but easy-to-follow discussion of the circumstances under which penalties are asserted. Educational material has been sent in the past with return forms but it has generally been limited to an announcement of current changes (such as Notice 786, which announced the increase in the failure to deposit penalty) and have not been comprehensive booklets. The IRS does publish a book entitled "TAX GUIDE FOR SMALL BUSINESS". However, it is much too technical and comprehensive for the average small businessman. We recommend that a booklet of the type discussed above be prepared and sent on a one-time basis to each filer of Form 941 and be sent on a continuing basis to each new filer of Form 941. A more aggressive dissemination is needed than is usual for the IRS because the small businessman will likely not even know that it is available unless it is sent to him. As a minimum, it should be advertised by an announcement distributed to all filers, with a booklet made available on request.

(9) There is a massive amount of paperwork (72 million deposits) involving a large number of persons (5.5 million business filers and 34,000 financial institutions) in the Federal Tax Deposit system. This, coupled with the compressed time scale (three banking days when the tax liability is over $3000 in any 1/8th month period) has resulted in a system that is error prone and time-sensitive. In addition to the errors to be expected in processing such massive amounts of data in a decentralized fashion, there may be some banks that have purposely credited monies late in order to use the monies as interest-free float. A cancelled check was available as proof in almost half of the cases for which the taxpayer claimed that the penalty was erroneously imposed (Table 5). The use of an administrative tolerance of several days in determining whether the FTD was timely should substantially reduce the number of erroneous penalties imposed for untimely deposits. There is precedence for this procedure in the administrative tolerance used for imposing the penalty for untimely filing of returns.



Form **941**
(Rev. January 1988)
Department of the Treasury
Internal Revenue Service

4141

Employer's Quarterly Federal Tax Return

▶ For Paperwork Reduction Act Notice, see page 2.
Please type or print.

OMB No 1545-0029
Expires 8-31-88

Your name, address, employer identification number, and calendar quarter of return. (If not correct, please change.) ▶

Name (as distinguished from trade name)
Date quarter ended
Trade name, if any
Employer identification number
Address and ZIP code

If you are not liable for returns in the future, check here . . . ▶ ☐ Date final wages paid . . . ▶

Complete for First Quarter Only

1a	Number of employees (except household) employed in the pay period that includes March 12th . ▶	1a
b	If you are a subsidiary corporation AND your parent corporation files a consolidated Form 1120, enter parent corporation employer identification number (EIN) . ▶ | 1b | –	
2	Total wages and tips subject to withholding, plus other compensation . . . . ▶	2
3	Total income tax withheld from wages, tips, pensions, annuities, sick pay, gambling, etc. . . ▶	3
4	Adjustment of withheld income tax for preceding quarters of calendar year (see instructions) . ▶	4
5	Adjusted total of income tax withheld	5
6	Taxable social security wages paid . . . . $ ______ × 15.02% (.1502)	6
7a	Taxable tips reported . . . . . $ ______ × 15.02% (.1502)	7a
b	Taxable hospital insurance wages paid . . . $ ______ × 2.9% (.029)	7b
8	Total social security taxes (add lines 6, 7a, and 7b)	8
9	Adjustment of social security taxes (see instructions for required explanation)	9
10	Adjusted total of social security taxes (see instructions) . . . . ▶	10
11	Backup withholding (see instructions)	11
12	Adjustment of backup withholding tax for preceding quarters of calendar year . . . . ▶	12
13	Adjusted total of backup withholding	13
14	Total taxes (add lines 5, 10, and 13)	14
15	Advance earned income credit (EIC) payments, if any . . . . ▶	15
16	Net taxes (subtract line 15 from line 14). **This must equal line IV below** (plus line IV of Schedule A (Form 941) if you have treated backup withholding as a separate liability).	16
17	Total deposits for quarter, including overpayment applied from a prior quarter, from your records . ▶	17
18	Balance due (subtract line 17 from line 16). This should be less than $500. Pay to IRS . . . . ▶	18
19	If line 17 is more than line 16, enter overpayment here ▶ $ ______ and check if to be: ☐ Applied to next return **OR** ☐ Refunded	

Record of Federal Tax Liability (Complete if line 16 is $500 or more.) See the instructions under rule 4 for details before checking these boxes.

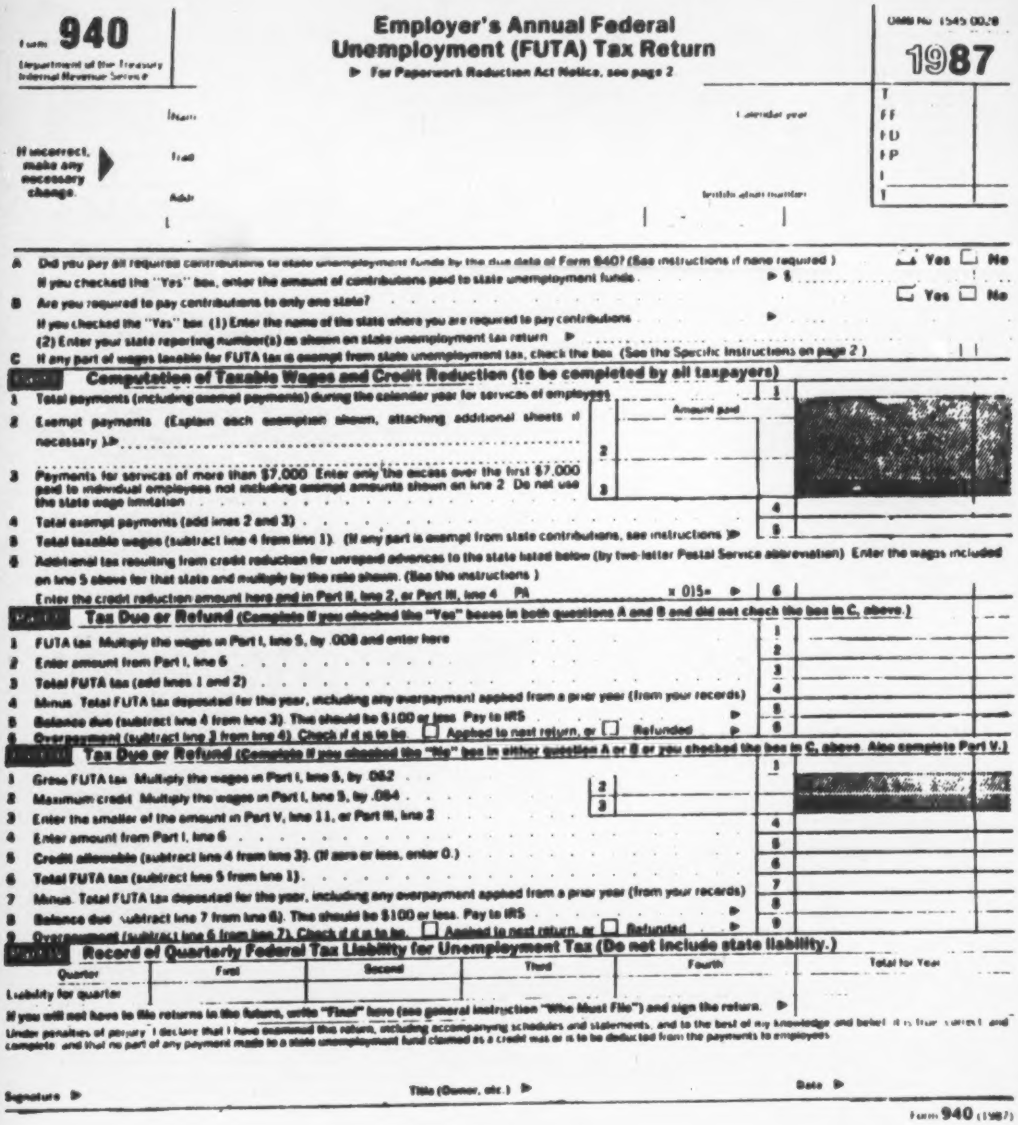
Check only if you made eighth-monthly deposits using the 95% rule ▶ ☐ Check only if you are a first time 3-banking-day depositor ▶ ☐

▶ Do NOT Show Federal Tax Deposits Here ▶

Date wages paid	Tax liability ▼ *Do NOT Show Federal Tax Deposits Below* ▼					
	First month of quarter		Second month of quarter		Third month of quarter	
1st through 3rd	A		I		Q	
4th through 7th	B		J		R	
8th through 11th	C		K		S	
12th through 15th	D		L		T	
16th through 19th	E		M		U	
20th through 22nd	F		N		V	
23rd through 25th	G		O		W	
26th through the last	H		P		X	
Total liability for month	*I*		*II*		*III*	
IV Total for quarter (add lines *I*, *II*, and *III*). **This must equal line 16 above** . . . . ▶						

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete.

Signature ▶ Title ▶ Date ▶



Form **940**

Department of the Treasury
Internal Revenue Service

Employer's Annual Federal Unemployment (FUTA) Tax Return

▶ For Paperwork Reduction Act Notice, see page 2

OMB No. 1545-0028

1987

If incorrect, make any necessary change. ▶

Name

Trade

Address

Calendar year

Employer identification number

T
FF
FD
FP
I
T

A Did you pay all required contributions to state unemployment funds by the due date of Form 940? (See instructions if none required.) ☐ Yes ☐ No

If you checked the "Yes" box, enter the amount of contributions paid to state unemployment funds ▶ $ ....

B Are you required to pay contributions to only one state? ☐ Yes ☐ No

If you checked the "Yes" box (1) Enter the name of the state where you are required to pay contributions ▶ ....

(2) Enter your state reporting number(s) as shown on state unemployment tax return ▶ ....

C If any part of wages taxable for FUTA tax is exempt from state unemployment tax, check the box. (See the Specific Instructions on page 2.) ☐

Part I Computation of Taxable Wages and Credit Reduction (to be completed by all taxpayers)

1	Total payments (including exempt payments) during the calendar year for services of employees			1
			Amount paid	
2	Exempt payments. (Explain each exemption shown, attaching additional sheets if necessary.) ▶	2		
3	Payments for services of more than $7,000. Enter only the excess over the first $7,000 paid to individual employees not including exempt amounts shown on line 2. Do not use the state wage limitation	3		
4	Total exempt payments (add lines 2 and 3)			4
5	Total taxable wages (subtract line 4 from line 1). (If any part is exempt from state contributions, see instructions.) ▶			5

6 Additional tax resulting from credit reduction for unrepaid advances to the state listed below (by two-letter Postal Service abbreviation). Enter the wages included on line 5 above for that state and multiply by the rate shown. (See the instructions.)

Enter the credit reduction amount here and in Part II, line 2, or Part III, line 4 PA .... × .015= ▶ 6

Part II Tax Due or Refund (Complete if you checked the "Yes" boxes in both questions A and B and did not check the box in C, above.)

1	FUTA tax. Multiply the wages in Part I, line 5, by .008 and enter here	1
2	Enter amount from Part I, line 6	2
3	Total FUTA tax (add lines 1 and 2)	3
4	Minus: Total FUTA tax deposited for the year, including any overpayment applied from a prior year (from your records)	4
5	Balance due (subtract line 4 from line 3). This should be $100 or less. Pay to IRS ▶	5
6	Overpayment (subtract line 3 from line 4). Check if it is to be: ☐ Applied to next return, or ☐ Refunded ▶	6

Part III Tax Due or Refund (Complete if you checked the "No" box in either question A or B or you checked the box in C, above. Also complete Part V.)

1	Gross FUTA tax. Multiply the wages in Part I, line 5, by .062		1
2	Maximum credit. Multiply the wages in Part I, line 5, by .054	2	
3	Enter the smaller of the amount in Part V, line 11, or Part III, line 2	3	
4	Enter amount from Part I, line 6		4
5	Credit allowable (subtract line 4 from line 3). (If zero or less, enter 0.)		5
6	Total FUTA tax (subtract line 5 from line 1)		6
7	Minus: Total FUTA tax deposited for the year, including any overpayment applied from a prior year (from your records)		7
8	Balance due (subtract line 7 from line 6). This should be $100 or less. Pay to IRS ▶		8
9	Overpayment (subtract line 6 from line 7). Check if it is to be: ☐ Applied to next return, or ☐ Refunded ▶		9

Part IV Record of Quarterly Federal Tax Liability for Unemployment Tax (Do not include state liability.)

Quarter	First	Second	Third	Fourth	Total for Year
Liability for quarter					

If you will not have to file returns in the future, write "Final" here (see general instruction "Who Must File") and sign the return. ▶

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief it is true, correct, and complete, and that no part of any payment made to a state unemployment fund claimed as a credit was or is to be deducted from the payments to employees.

Signature ▶ Title (Owner, etc.) ▶ Date ▶

Form **940** (1987)

After the end of the year, give each annuitant a Form W-2P showing the gross payments and the income tax withheld during the year. (See section 17.)

Withholding on Nonperiodic Payments.—For information on withholding from nonperiodic payments and the tables for withholding on qualified total distributions, see Publication 493.

Periodic Payments and Nonperiodic Distributions Delivered Outside the U.S.—A recipient of any such payment or distribution that is delivered outside the U.S. cannot choose exemption from withholding unless the recipient certifies to the payer that the recipient is not (1) a U.S. citizen who is a bona fide resident of a foreign country; or (2) an individual to whom Internal Revenue Code section 877 applies (concerning expatriation to avoid tax). The certification can be made in a statement to the payer under the penalties of perjury.

Caution: *Under pending legislation, U.S. possessions would be considered not to be outside the U.S. in determining when a certification was necessary. The legislation would also require recipients choosing exemption from withholding to certify that they were not U.S. citizens or resident aliens.*

13. Depositing Taxes

Use Form 8109, Federal Tax Deposit Coupon, to deposit employment taxes and all other types of taxes that are deposited. Do not use the deposit coupons to pay delinquent taxes for which you have been assessed by the IRS. These payments should be sent directly to your Internal Revenue Service Center along with a copy of any related notice the IRS sent you.

The IRS will send you a coupon book after you apply for an employer identification number. The coupons will be preprinted with your name, address, and employer identification number. They have entry boxes for indicating the type of tax and the tax period against which the deposit is to be applied. **Note:** *It is very important to clearly mark the correct type of tax and tax period on each deposit coupon. This information is used by the IRS to credit your account.*

When you need more coupons, order them from your Internal Revenue Service Center, using **Form 8109A,** FTD Reorder Form, that is included in the coupon book. Your coupons will be sent to the address preprinted on the reorder form, which may not be your IRS account address (the address the IRS uses to send you your tax returns, refunds, and notices). If you want them sent to a different address, show that new information on the reorder form. That will become the address on your deposit coupons. Your IRS account address will not change even if you have your coupons sent to a different address. **Note:** *You should receive your reorder in approximately 5-6 weeks. Be sure to allow ample reorder time before you use up your current supply.*

If you have branch offices depositing taxes, give them coupons so they can deposit the taxes when due.

Please do not use anybody else's coupons. If you do so, you may be subject to the failure to deposit penalty. This is because your account will be underpaid by the amount of the deposit credited to the other person's account. The penalty is 10% of the underpayment.

Mail or deliver each deposit coupon and a single payment covering the taxes to be deposited to a financial institution qualified as a depositary for Federal taxes or to the Federal Reserve Bank or branch (FRB) serving your geographical area. Follow the instructions in the front of the coupon book. Make the check or money order payable to the depositary or FRB where you make your deposit. To help ensure proper crediting of your account, include your employer identification number, the type of tax (e.g., Form 940), and tax period to which the payment applies on your check or money order.

Reporting Agents.—Reporting agents who submit Federal employment tax deposits for their clients should see Rev. Proc. 86-33, 1986-2 C.B. 42[illegible] for details.

Deposits at Authorized Financial Institutions.—Authorized depositaries must accept cash, a postal money order drawn to the order of the depositary, or a check or draft drawn on and made payable to the depositary. You can deposit taxes with a check drawn on another financial institution only if the depositary is willing to accept that form of payment.

Deposits at FRBs.—If you use a check to deposit taxes at an FRB, please deposit with the FRB that serves your area. The check must be considered by that FRB as an immediate credit item. Generally, immediate credit items include checks drawn on commercial banks located in the same city as the FRB to which the deposit is mailed. You can learn which FRB serves your area, and what checks are immediate credit items, from any commercial bank or FRB.

Depositing on Time.—The timeliness of deposits will be determined by the date received by an authorized depositary or FRB. However, a deposit received after the due date of the deposit will be considered timely if you show that it was mailed by the second day before the due date. **Note:** *Deposits of $20,000 or more, which are made by taxpayers required to deposit any taxes more than once a month, must be received by the due date of the deposit to be timely; the 2-day mail rule does not apply to these deposits.*

If a deposit that does not comply with the deposit payment requirements is made at an FRB, that deposit will be dated on collection of the funds by the FRB, regardless of when mailed.

If you hand deliver your deposit to the depositary on the due date, be sure to deliver it before the depositary closes its business day.

Depositing Without a Coupon or EIN.—If you have applied for an employer identification number but have not received it, and you must make a deposit, make the deposit with your Internal Revenue Service Center rather than with a depositary or FRB. Make it payable to IRS and show on it your name (as shown on Form SS-4), address, kind of tax, period covered, and date you applied for an EIN. Attach an explanation to the deposit.

If you have reordered coupons and have not received them in time to make a deposit, or if you are a new employer and have already received your employer identification number but have not yet received your initial supply of deposit coupons, use **Form 8109-B**. This over-the-counter deposit coupon is available at most IRS offices. Deposit Form 8109-B deposit coupons with an authorized depositary or FRB only.

Deposit Record.—For your records, a stub is provided with each coupon in the coupon book. The coupon itself will not be returned. It is used to credit your account. Your check or money order is your receipt.

How To Claim Credit for Overpayments.—If you deposited more than the right amount of taxes for a quarter, you can ask on the tax return you file to have the overpayment refunded or applied as a credit to your next return.

Penalties.—A 10% penalty is charged when taxes are not deposited when due or when Federal tax deposits are mailed or delivered to IRS offices rather than to authorized depositaries or FRBs. However, see *Depositing Without a Coupon or EIN,* above. A 25% penalty is charged when deposits are overstated. An overstated deposit is an amount claimed on any return as having been deposited that exceeds the amount actually deposited by the date the return is filed. In both situations, the penalties will not be charged if the failure to deposit or the overstatement was due to reasonable cause, and not due to willful neglect. When credit is claimed on the return for deposits not made, fines and other criminal penalties may be charged.

Separate Accounting When Deposits Are Not Made or Withheld Taxes Are Not Paid.—Separate accounting may be required if you do not pay over withheld employee social security tax or income tax, deposit required taxes, make required payments, or file tax returns. In this case, you would receive written notice from the district director requiring you to deposit taxes in a special trust account for the U.S. Government. You would also have to file monthly tax returns on **Form 941-M,** Employer's Monthly Federal Tax Return. Penalties are provided for not depositing taxes and not making payments.

When To Deposit.—The amount of taxes determines the frequency of deposits. You owe these taxes when you pay the wages, not when your payroll period ends. The rules and examples below explain how often to deposit taxes.

Note: *If any date shown falls on a Saturday, Sunday, or legal holiday, use the next regular workday for depositing taxes.*

Depositing Withheld Income and Social Security Taxes.—

Rule 1—Less than $500 at end of quarter.—If at the end of the calendar quarter your total undeposited taxes for the quarter are less than $500, you do not have to deposit the taxes. You may pay the taxes to IRS with Form 941 (or 941E), or you may deposit them by the end of the next month.

Rule 2—Less than $500 at the end of any month.—If at the end of any month your total undeposited taxes are less than $500, you do not have to make a deposit. You may carry the taxes over to the following month within the quarter. (See Example A.)

Rule 3—$500 or more but less than $3,000 at the end of any month.—If at the end of any month your total undeposited taxes are $500 or more but less than $3,000, you must deposit the taxes within 15 days after the end of the month.

Exception: If this occurs at the end of a month in which you were required to make a deposit of $3,000 or more, see Examples D and E.

Rule 4—$3,000 or more at the end of any eighth-monthly period.—Each month is divided into eight deposit periods that end on the 3rd, 7th, 11th, 15th, 19th, 22nd, 25th, and last day of the month. If at the end of any eighth-monthly period your total undeposited taxes are $3,000 or more, deposit the taxes within 3 banking days after the end of that eighth-monthly period. (See Examples B, C, D, and E.) Do not count as banking days local holidays observed by authorized financial institutions, Saturdays, Sundays, and legal holidays.

You will be considered to meet rule 4 if:

- You deposit at least 95% of the tax liability for that eighth-monthly period within 3 banking days after the end of that period; and
- You deposit any underpayment as follows:

(a) If an eighth-monthly period is in the first or second month of the quarter, you deposit the underpayment with the first deposit that is required to be made after the 15th of the following month.

(b) If an eighth-monthly period is in the last month of the quarter, you deposit any underpayment of $500 or more by the due date of the return. (Any underpayment less than $500 can be paid with Form 941 (or 941E) as explained in rule 1.)

Exception: If this is the first time you are required to make a deposit within 3 banking days after the end of an eighth-monthly period, you may deposit the taxes by the 15th of the next month (instead of within 3 banking days after the eighth-monthly period) if you meet all of the following conditions:

- You were not required to deposit taxes under rule 4 during the 4 quarters preceding the current quarter.
- You were not required to deposit taxes under rule 4 during earlier months of this quarter.
- Your total undeposited taxes at the end of any eighth-monthly period during this month are less than $10,000.

Example A.—The taxes on wages paid in October are $450, and the taxes on wages paid in November are $550. No deposit is required for October (because of rule 2), but add the $450 to the $550 for November and deposit the total ($1,000) by December 15 (as required by rule 3).

Example B.—The taxes on wages paid from the 1st through the 3rd of the month are $3,500. Deposit these taxes within 3 banking days after the 3rd of the month (as required by rule 4).

Example C.—The taxes on wages paid from the 4th through the 7th of a month are $2,500 and the taxes on wages paid from the 8th through the 11th are $2,000. A separate deposit is not required for the $2,500, but add it to the $2,000 and deposit the total ($4,500) within 3 banking days after the 11th of the month (as required by rule 4).

Example D.—The taxes on wages paid from the 23rd through the 25th of January are $3,500. Deposit these taxes within 3 banking days after the 25th of the month (as required by rule 4). The taxes on wages paid from the 26th through the end of January are $2,500. Since a deposit was already required to be made for an eighth-monthly period during the month, a separate deposit is not required for the $2,500 (because of the exception to rule 3). Carry the $2,500 over and add it to the taxes on wages paid in February. Then follow rules 3 and 4 to determine when the next deposit is required. (However, if this occurs in the last month of a quarter, deposit any balance due of $500 or more but less than $3,000 by the end of the next month.)

Example E.—Wages are paid on Friday for the prior week. In the first quarter of 1988, paydays are on January 1, 8, 15, 22, and 29; February 5, 12, 19, and 26; and March 4, 11, 18, and 25. Taxes are $1,050 for each payday.

Enter $1,050 on lines A, C, D, F, H, J, L, M, P, R, S, U, and W of Form 941. Enter $5,250 on Total line I; $4,200 on lines II and III; and $13,650 on line IV.

You must make a deposit within 3 banking days of January 15, February 7, February 29, and March 19 because undeposited taxes reached at least $3,000 for the eighth-monthly periods ending on those dates.

The undeposited taxes at the end of January of $2,100 (for paydays on the 22nd and 29th) may be carried over to February because of the exception to rule 3 as explained in Example D. At the end of February, there is no carryover since the undeposited taxes are $3,150 and must be deposited within 3 banking days. At the end of March, the undeposited taxes of $1,050 (for the payday on the 25th) must be deposited by April 30 (because of the exception to rule 3 for the last month of a quarter as explained in Example D).

Depositing Backup Withholding.—For tax deposit purposes, you can either combine backup withholding with other taxes reported on Form 941 or 941E and deposit the combined total, or you can treat backup withholding as a separate tax and deposit it separately following the same deposit rules used for social security and withheld income taxes.

If you treat backup withholding as a separate tax, show the amounts for deposit purposes on **Schedule A (Form 941), Record of Federal Backup Withholding Tax Liability**, and when depositing this tax, darken the "Sch. A" entry box on the deposit coupon. Schedule A (Form 941) must be attached to Form 941 or 941E.

Deposit Instructions for State and Local Government Employers.—If you are not covered by a section 218 agreement, deposit withheld income tax and (for employees hired after March 31, 1986) the medicare portion only of social security tax. Follow rules 1 through 4 on pages 8 and 9. If you are covered by a section 218 agreement, deposit income tax and social security taxes following the rules on pages 8 and 9, subject to the following modification for social security taxes: For wages paid after September 30, 1987, and before October 1, 1988, you may use a 5-day rule instead of the 3-day rule described in rule 4. Wages paid after September 30, 1988, are subject to the 3-day rule, and social security taxes and withheld income tax must be added together to figure when to make a deposit.

Deposit with authorized depositaries and FRBs only; do not send the social security taxes to the state. **Note:** *Remember that if you are covered by a section 218 agreement, you may figure the deposit schedule for social security taxes separately from the deposit schedule for withheld income tax (for wages paid before October 1, 1988). Use separate Form 8109 deposit coupons if you are figuring the deposit schedules separately.*

Summary of Deposit Rules for Social Security Taxes and Withheld Income Tax

Deposit Rule	Deposit Due
(1) If at the end of the quarter your total undeposited taxes for the quarter are less than $500	(1) No deposit is required. You may pay the taxes to IRS with Form 941 (or 941E), or you may deposit them by the due date of the return
(2) If at the end of any month your total undeposited taxes are less than $500	(2) No deposit is required. You may carry the taxes over to the following month
(3) If at the end of any month your total undeposited taxes are $500 or more but less than $3,000.	(3) Within 15 days after the end of the month. (No deposit is required if you were required to make a deposit for an eighth-monthly period during the month under rule 4. However, if this occurs in the last month of the quarter, deposit any balance due by the due date of the return.)
(4) If at the end of any eighth-monthly period (the 3rd, 7th, 11th, 15th, 19th, 22nd, 25th, and last day of each month) your total undeposited taxes are $3,000 or more	(4) Within 3 banking days after the end of that eighth-monthly period. (May be 5 days, see *Deposit Instructions for State and Local Government Employers* above.)

Depositing Federal Unemployment (FUTA) Taxes.—

For deposit purposes, figure FUTA tax quarterly. Deposit any amount due by the last day of the first month after the quarter ends.

Determine whether you must deposit tax for any of the first 3 quarters in a year. Figure the total tax by multiplying by .008 that part of the first $7,000 of each employee's annual wages that you paid during the quarter.

If this amount (plus any amount not yet deposited for any earlier quarter of the year) is more than $100, deposit it during the first month after the quarter. But if it is $100 or less, you do not have to deposit it. Just add it to the amount for deposit for the next quarter.

If the tax reportable on Form 940 (including any credit reductions under Code section 3302(c)), minus amounts deposited for the year, is more than $100, deposit all of the tax by January 31. If your tax for the year (minus deposits) is $100 or less, you may either deposit it or pay it with Form 940 by January 31.

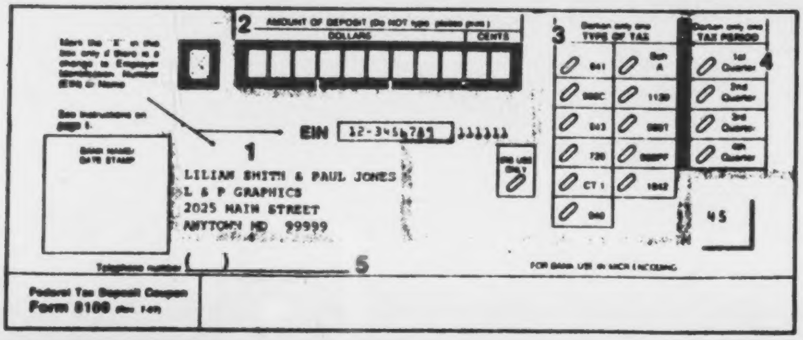
14. Filing the Quarterly Return of Withheld Income Tax and Social Security Taxes

Form 941.—Generally, all employers who are subject to income tax withholding or social security taxes must file Form 941 quarterly. However, there are the following exceptions:

(a) Employers who report only withheld income tax or who withheld the medicare portion only of social security tax. These include certain state and local governments, payers of supplemental unemployment compensation benefits, churches and church-controlled organizations that have filed Form 8274, and certain payers of pensions, annuities, and sick pay. These employers should use Form 941E.

(b) Household employers reporting social security taxes and withheld income tax. Report these on Form 942.

Federal Tax Deposit (FTD) Checklist



Mark the "X" in this box only if there is a change to Employer Identification Number (EIN) or Name ☐

See instructions on page 1.

2 AMOUNT OF DEPOSIT (Do NOT type, please print)

DOLLARS	CENTS

3 Darken only one TYPE OF TAX

○ 941	○ Sch A
○ 990C	○ 1120
○ 943	○ 990T
○ 720	○ 990PF
○ CT 1	○ 1042
○ 940	

Darken only one TAX PERIOD 4

○ 1st Quarter
○ 2nd Quarter
○ 3rd Quarter
○ 4th Quarter

EIN 12-3456789 111111

1

BANK NAME/DATE STAMP

LILIAN SMITH & PAUL JONES
L & P GRAPHICS
2025 MAIN STREET
ANYTOWN MD 99999

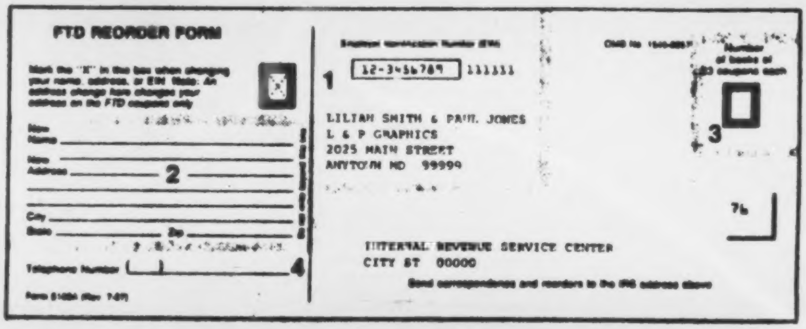
IRS USE ONLY ○

45

Telephone number ( ) ________ 5

FOR BANK USE IN MICR ENCODING

Federal Tax Deposit Coupon
Form 8109 (Rev. 1-87)



FTD REORDER FORM

Mark the "X" in this box when changing your name, address, or EIN. Note: An address change here changes your address on the FTD coupons only ☒

New Name ________

New Address ________ 2 ________

City ________

State ________ Zip ________

Telephone Number ( ) ________ 4

Form 8109A (Rev. 7-87)

Employer Identification Number (EIN)

1 12-3456789 111111

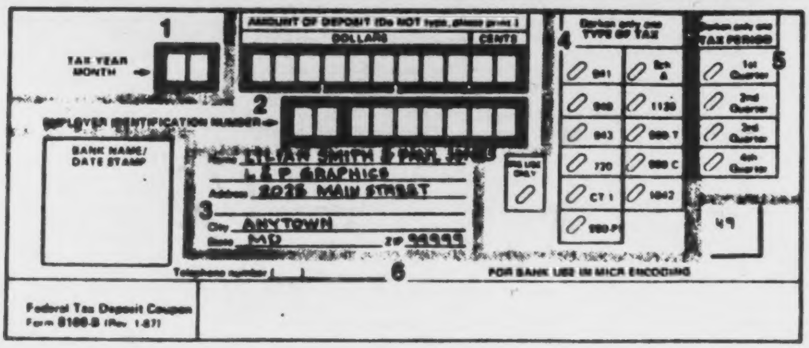
LILIAN SMITH & PAUL JONES
L & P GRAPHICS
2025 MAIN STREET
ANYTOWN MD 99999

Number of books of 23 coupons each ☐ 3

76

INTERNAL REVENUE SERVICE CENTER
CITY ST 00000

Send correspondence and reorders to the IRS address above



1

TAX YEAR MONTH → ☐☐

AMOUNT OF DEPOSIT (Do NOT type, please print)

DOLLARS	CENTS

2

EMPLOYER IDENTIFICATION NUMBER → ☐☐ ☐☐☐☐☐☐☐

4 Darken only one TYPE OF TAX

○ 941	○ Sch A
○ 990	○ 1120
○ 943	○ 990 T
○ 720	○ 990 C
○ CT 1	○ 1042
○ 990 PF	

Darken only one TAX PERIOD 5

○ 1st Quarter
○ 2nd Quarter
○ 3rd Quarter
○ 4th Quarter

BANK NAME/DATE STAMP

Name LILIAN SMITH & PAUL JONES
L & P GRAPHICS
Address 2025 MAIN STREET
3
City ANYTOWN
State MD Zip 99999

IRS USE ONLY ○

49

Telephone number ( ) ________ 6

FOR BANK USE IN MICR ENCODING

Federal Tax Deposit Coupon
Form 8109-B (Rev. 1-87)

Please fill out forms in #2 pencil.

Federal Tax Deposit Coupon

Form 8109

1. Verify your name and employer identification number (EIN) on the preprinted label. This will ensure that your deposit is applied to the proper account. To indicate a change, place an "X" in the box and enter the correct name and EIN. DO NOT MAKE ADDRESS CHANGES. Address changes should only be made when reordering coupons on Form 8109A. (See below.)

2. Write in the money amount—do not type. Also, do not enter dollar signs, commas, decimal points, or leading zeroes. If your deposit is for whole dollars only, be sure to enter "00" in the "CENTS" boxes.

3. To indicate the type of tax, darken the box to the left of the appropriate form. Do not darken the "IRS USE ONLY" box.

4. Always darken the box indicating the quarter that the deposit is for—not the quarter in which you are making the deposit. For payroll, withholding, and excise tax deposits, the quarters are:

1st quarter – Jan. 1 through Mar. 31   3rd quarter – July 1 through Sept. 30
2nd quarter – Apr. 1 through June 30   4th quarter – Oct. 1 through Dec. 31

For business income tax deposits (this includes the excise tax on net investment income for Form 990-PF filers) darken the first quarter box for deposits made before the end of your tax year. Darken the fourth quarter box for deposits made after the end of the year. Deposits for different types of taxes and for different quarters cannot be combined. Each needs its own deposit coupon.

If you need additional FTD coupons, use Reorder Form 8109A provided in the coupon book. See below for additional information on reordering.

5. Be sure to include your daytime telephone number in the space provided.

FTD Reorder Form

Form 8109A

1. Verify your employer identification number (EIN), name, and address. Check the box if there is any change. If your EIN is incorrect, line through the number and enter the correct EIN.

2. If there is a change to your name and/or address, enter the new name and/or address in this area.

3. FTD coupon books now contain 23 coupons. Request coupon books early enough to make your deposits on time, since it takes five to six weeks to receive your new coupon books. Be sure to mail your reorder to the Internal Revenue Service Center address shown on the reorder form.

Do not make any additional entries on this form, such as "Please rush my order." This results in manually processing your request and may delay receipt of the coupons by approximately two weeks.

4. Be sure to include your daytime telephone number in the space provided.

Federal Tax Deposit Coupon

Form 8109-B

1. Enter the month that your tax year ends in this space if you are filing in the 1120, 990-C, 990-PF, or 990-T box; otherwise, leave it blank. For example, if your tax year ends in January, enter 01; if it ends in December, enter 12.

2. Write in your EIN and the money amount. Do not type it in or use dollar signs, commas, decimal points, or leading zeroes. Be sure to enter "00" in the "CENTS" boxes if your deposit is for whole dollars only.

3. To ensure proper credit to your account, use the name and address as shown on your IRS mailing label found on the current business tax forms mailed to you, such as Form 940, 941, etc. This is your correct IRS account identification.

4. To indicate the type of tax, darken the box to the left of the appropriate form. Do not darken the "IRS USE ONLY" box.

5. Darken the box to the left of the quarter that corresponds to the quarter that the deposit is for—not the quarter in which you are making the deposit. For payroll, withholding, and excise tax deposits, the quarters are:

1st quarter – Jan. 1 through Mar. 31   3rd quarter – July 1 through Sept. 30
2nd quarter – Apr. 1 through June 30   4th quarter – Oct. 1 through Dec. 31

For business income tax deposits (this includes the excise tax on net investment income for Form 990-PF filers), darken the first quarter box for deposits made before the end of your tax year. Darken the fourth quarter box for deposits made after the end of the year.

If you need coupon books and don't have a Reorder Form 8109A, call the IRS or write your Internal Revenue Service Center and provide the following information: business name, address where you want the coupon books sent, number of coupon books, and EIN. Also include the month in which your tax year ends if you have a Form 1120, Form 990-C, Form 990-PF (with net investment income), Form 990-T, or Form 2438 filing requirement.

6. Be sure to include your daytime telephone number in the space provided.

Chairman PICKLE. Thank you, Mr. Swain.

I notice in making these recommendations you say it has been the result of a lengthy study of your agency because it is troublesome for you.

Mr. SWAIN. Yes.

Chairman PICKLE. And you have made some rather critical statements of the number of penalties of up to 20 to 29 percent, 25 percent have been abated. That means 1 out of every 4, as you said, are in error. In arriving at these recommendations, have you discussed these with the Internal Revenue Service?

Mr. SWAIN. Yes, sir, we have.

Chairman PICKLE. When did you talk with them about it?

Mr. SWAIN. I did not personally discuss recommendations, but members of my staff have had continual discussions and meetings. I believe the specific date of a meeting where we presented our draft final report was the first week in June. We had a number of people from my office as well as a number of people from the Service. The response to that meeting was that the Service gave us an informal written response, and we gave them an informal response back. And we did change and adjust a number of things in the report based on their reaction.

I cannot say that we agreed with their reaction on everything, but we have had continual discussions back and forth.

Chairman PICKLE. Well, you are not being very helpful to me, at least as I understand your statement. You have talked with them and they responded. Now, what did they respond? Did they agree or disagree with your analysis?

Mr. SWAIN. My characterization, Mr. Chairman, would be that they agreed that there is a problem. I do not believe they agreed that every one of the recommendations we made would either necessarily solve the problem or was practical for them to implement over the short term. They, I think, agree that there is a problem with the payroll tax penalty and abatement structure.

Chairman PICKLE. Now, you stated that although the penalties were high, you did not blame the Internal Revenue Service entirely because you said it could have been the IRS errors or it could be the FTD reporting, failure of the banks to send their records, or the Reserve system's delay. You list about five reasons.

Now, that would seem to me to say that while the Internal Revenue makes the final decision for an abatement or reduction, it can be based on a number of reasons, and you do not know why they made their abatement. So it could be their error, IRS error, or a number of other categories.

Is there any way for us to know what would be the predominant violation? You said that the most troublesome thing to you was the IRS errors. Do you think that is the most serious reason for these high number abatements?

Mr. SWAIN. Mr. Chairman, what we know for sure is how many penalties there were and how many abatements there were. We do not know, and only the IRS knows—and I do not really think they know because they have not done the analysis. But they could know, they could do an analysis of what the exact reasons for the various types of abatements are.

We did our survey. We asked the taxpayers in the survey: Why did you get penalized, and why, if there was an abatement, was the penalty abated? And 2 out of 3 of the taxpayers that had an abatement replied that they felt that it was the IRS' fault, not their fault.

Now, Mr. Chairman, that is about as much as I can say. The taxpayer may be right or may be wrong. That is as far as we can go with our ability to research the issue. We cannot get into the IRS' computers and figure it out any more than that.

Chairman PICKLE. Let me make an observation and then a question to you. I do not know whether the percentage of abatement, at 20 or 25 percent, is a high figure or not. I would first ask myself: Is it normal and natural and reasonable for a certain number of abatements to be made at the final end of the pipeline?

It would appear to me that that would be a little high, but there would be any number of reasons. I do not want to be alarmed just because it is a high figure in itself to the average person who reads the statement of the figure.

But I am just wondering, is that too high? And if it is too high—and I would presume that it would appear to be too high—I would want to know more specifics. What do we do about it, or can we do something about it?

Now, I want to be as helpful to small business as we can. I want those specific recommendations that you made. Now, we have your recommendations in some of these categories, and I think they are going to be helpful to us.

We will present this testimony and question to the Internal Revenue Service for further response because we will have another hearing on this issue before we make our recommendations, assuming that we do. So we will be anxious to know specifically what the response is to your observation.

Mr. SWAIN. Yes, sir.

Chairman PICKLE. Have you got any specific analysis about what you think is the main error and how we can correct it? We would like to have that additional statement from you.

Mr. SWAIN. I will certainly provide that, Mr. Chairman. And I will note that you ask a very important question: How high is too high in terms of the abatements? The IRS Commissioner's annual reports indicate that as recently as 1981, they were only abating 12 percent of the penalties. Now they are abating 25 percent of the penalties.

Chairman PICKLE. All right. Now, why do you think that an increase has occurred during the period of 1984, 1985, and 1986? Is it because of the tax laws we passed, or did they get bogged down with computer problems, the "computer glitch"? Why has it picked up, in your opinion, so heavily during these last 4 years?

Mr. SWAIN. I think you identified two of the major factors. As you know, Mr. Chairman, the Congress has at least twice, I think—and is considering in current legislation—changing and accelerating the payment schedules for tax withholding. In addition, as you know, the rates for Social Security tax, both the rate and the amount to be subject to withholding, has increased every year.

So for the business taxpayer, the rules have been a moving target. There are lots of good tax policy and revenue reasons for that, but the result for somebody filling out the forms is that they have been very much a moving target.

The second factor, and I think it perhaps explains some of the difficulty in the mid-1980's, is the very well publicized—and I know this committee had oversight hearings on it—computer problems at the IRS. Although most of the public attention, as I recall, was focused on the income tax problems, part of that is the withholding tax paid by the employer.

If the high water mark for penalties and abatements were 1984 or 1985, I would not come here and make such a disturbing case, I guess. But the point is that even in the 1987 figures that the Commissioner has published, the penalties are way up again.

So that indicates to me that while computers might have been some problem in the mideighties, that is certainly not the entire problem.

Chairman PICKLE. All right, Mr. Swain.

Mr. Schulze?

Mr. SCHULZE. Thank you, Mr. Chairman.

Thank you, Frank, for your testimony. We perhaps often forget that there is a certain lack of sophistication sometimes in the small business community that makes it difficult for them to be aware of some of these latest proposals, and also to comply with some of the requirements. So I am glad that you have brought some of these things to our attention and also made suggestions on how to cure them.

I would like you to go into a little more detail on timely deposits in banks and some of the problems which you have brought to light, if you will.

Mr. SWAIN. Well, there are, I guess, several ways the business taxpayer can trip into a penalty situation. The time in which the taxpayer must deposit taxes is dependent on the amount of taxes they collected, the amount of Social Security taxes paid by the employer and withheld from the employee's wages, and also——

Mr. SCHULZE. The frequency?

Mr. SWAIN [continuing]. The frequency of payment has to do with the amount collected. And if you collect $1,000 a day, you pay every 3 days. If you collect $1,000 a year, you may only pay monthly or even less often than that.

I believe that for the very largest business taxpayers, you may deposit as many as eight times a month, and it varies depending on the scale. That frequency of payment has been subject to statutory change at least once, and I think twice, within the last 8 years.

Mr. SCHULZE. It could impact on small businesses with rapid growth.

Mr. SWAIN. Well, absolutely, or even small businesses with rapid shrinkage. Many small businesses, particularly in construction, have very volatile work forces and by the way, our study reveals that the industry that seems to have the most penalties is construction. That makes perfect sense to me because they are most likely to have highly volatile employment, depending on their jobs, depending on the season. They may have a big payment one month and ought to be making payments three times a month; and nothing at all the next month and revert back to quarterly.

Mr. SCHULZE. That has been a problem for some time. Should we try to look at volatile industries as a special carve-out? Should we try to do something special? Or would that get us into more hot water?

Mr. SWAIN. Well, I have not given this a lot of consideration. I am not so sure that carving out businesses by industry would be the way to go. Perhaps one approach to take would be rather than the amount of money that is collected each month—in effect, an annualized basis, a little bit like we do on individual income tax quarterly payments. I am allowed to pay quarterly payments based on my previous year's income tax. The current law is if I had a $10,000 income tax last year and my quarterly payments are at least $10,000 this year, no matter how big my income might ever become, I am not going to be penalized.

Maybe that is a system that we ought to take a look at for the business taxpayer. If they had Social Security and wage withholding payments of *x* amount last year, they can stick to the same schedule on an annual basis and not worry about surges and drops in employment. I have not given this a lot of thought, but I would be happy to try to provide any further analysis. That would, though, provide a measure of predictability and greater simplicity than we have now.

Mr. SCHULZE. I interrupted you before when you were talking about banks and small businesses.

Mr. SWAIN. Well, there are a couple of other trip points: failure to file the proper return at the same time the money is paid, failure to file the return in the proper place, failure to pay the money in the proper place. And there are many instances where the money is sent to the IRS office where it should have been sent to the bank, things like that. And finally, a failure to pay the most——

Mr. SCHULZE. Is that a one-time problem? Do bookkeepers or do businesses——

Mr. SWAIN. One would hope so.

Mr. SCHULZE [continuing]. Once or twice, or is that——

Mr. SWAIN. I do not have any specific evidence. I would hope that any decent small business manager would make sure that that was a one-time problem.

And finally—and this is perhaps where the statutory penalty is most effective—the failure to make a timely deposit to the trust fund accounts, that is money that you collect for your employees' taxes. I understand and fully agree with the tax policy reasons for that. It's not the employer's money. They want to get it into the Service and get it credited to the taxpayer as quickly as possible.

But the penalty is a flat 10 percent of the amount unpaid. That flat 10 percent pertains whether the payment is 1 day late or 30 days late. It seems to me that if the purpose of the penalty is to induce greater compliance, a flat penalty is not the appropriate way to go. And the Congress might take a look at——

Mr. SCHULZE. In other words, there might be an incentive if you are going to be a day late, you might as well wait and pay it next month.

Mr. SWAIN. That seems to me sort of hard numbers as I look at it. There are some other penalties in the code that are cumulative.

And if it is *x* percent a month, and over *x* months then more kicks in. And that may be a better way to go.

Mr. SCHULZE. In your testimony you also mentioned the fact that there were some deposits which were made in a timely fashion but perhaps the banks were responsible for not crediting those accounts. I believe you used the term playing games by perhaps trying to take greater advantage of the float than they ordinarily might. Can you give me a little more detail on that.

Mr. SWAIN. Well, there are some number of penalties—and we do not know how many—that are, I suppose in the sort of cold way of looking at it neither the fault of the IRS nor the taxpayer, but the intermediary institution, the bank. We do not know from our survey how often that occurs. If that occurs, obviously the taxpayer probably says it is not my fault, the IRS should not penalize me.

I think, but I am not certain, that the IRS would be able—through a sample study of some of their penalties—to estimate how many problems are caused by intermediary institutions. I would be reluctant to hazard a guess. I would not guess that it would be that many, but I really do not know.

Mr. SCHULZE. But it did show up in your——

Mr. SWAIN. Yes. It did show up and the Service itself offered that as a plausible reason that they frequently abate penalties. And if they abate penalties under those circumstances, I think that is commendable and should be encouraged.

Mr. SCHULZE. Did they indicate whether they then penalized the bank or the intermediary?

Mr. SWAIN. To be very candid, Mr. Schulze, we did not ask the question of whether they go after the intermediary. I would expect that the law would give them some ability to do so, but I do not know what the administrative practice is.

Mr. SCHULZE. Does the business itself have any recourse against the bank?

Mr. SWAIN. I do not really believe that they do other than some sort of common law contract suit if that were possible. But I do not believe that there is any Federal right of action. I suppose the normal recourse is to use a different bank. Business people, small business owners especially, like predictability in their banking relationships as well as anything else.

Mr. SCHULZE. Any other major problems that we should address our attention to in relation to the small business community?

Mr. SWAIN. Well, I am fully cognizant of the concerns of the Service, that they have a gargantuan system to run with employment tax payments. It is the way we have decided to collect our taxes in this country, and by in large it is fairly efficient. On the other hand, it does seem to me the system needs to be improved.

I would suggest that the Congress be very reluctant to further change the payroll and withholding tax filing and payment periods. They have been changed a good deal, and I think that they have been accelerated about as much as they can be. In fact, I would suggest that if they would decelerate a little bit, and there was some relief from that, you might have fewer penalties. That is a revenue consideration, and I recognize that that cannot be done easily in this day and age.

But I also think that a great concern of the small business community is their frustration over not being able to reconcile or adjust a problem when it is discovered. They typically do not have a major or maybe even a smaller accounting firm that they can afford to pay a lot of money on an hourly basis to change an IRS clerical or computing error, a check that got crossed in the mail or a mistake on the form or something like that.

Mr. SCHULZE. How about advance notice of what they should do or information or data or instructions on what they should do and how they should do it, is that adequate?

Mr. SWAIN. Well, I can speak a little bit from personal experience. I employ somebody in our house. I have waded through the forms, the unemployment, the FUTA and the FICA and the income tax withholding payments. I like to think of myself as a reasonably intelligent person, and I really have to read it over a few times in order to figure out exactly what is to be done. This is undoubtedly an admission against interest, but I have been penalized because I just misread it the first time we had to file the payments. And the penalty was paid. I did not protest.

But I think that it is a complicated system, and I think that there could be some greater clarification in the explanation of the forms, and the explanation—most importantly, the explanation of why there is a penalty. Because in some cases that is sort of murky too.

Mr. SCHULZE. If you develop any recommendations along those lines, we would be happy to have them later on. I thank you for your testimony.

Mr. FLIPPO [presiding]. Thank you, Mr. Schulze.

Mr. Swain, I think your testimony is helpful to us in that you are certainly bringing to us the perception of the small business community, I assume, as determined in the survey. Is that essentially correct?

Mr. SWAIN. Yes, sir.

Mr. FLIPPO. The conclusions that you provide on page 8 that the payroll tax system has yielded results which are perceived as unfair to small employers is a message that we are very concerned about. The perception of fairness is very important. It is not a mere abstraction to this committee.

So I think that your testimony is helpful to bring us the perception. What we are trying to do now is to look carefully at the—what we can do about that perception, and what is the proof of the matter, so to speak.

And I believe in your testimony that you said that if others have better statistics, you are willing to look at those statistics. So while we may find some fault with the statistical methods or other approaches, it is still a valid message that you are bringing that we need to always be mindful of the perception of how the code operates.

Let me ask you then on page 5 of your testimony, the chart, if I might understand it better, and here I am trying to understand what your survey is saying and how much reliance we should put on your survey. Certainly we should use this as a means of seeking the factual situation.

But just to see what it is that your survey is suggesting, am I interpreting this chart correctly that you had a 26 percent—well, the bottom line of this chart as I read it is that about 37 percent of the penalties that were assessed were assessed in error. If your 64 percent of the respondents—you had 26 percent people respond——

Mr. SWAIN. Yes, sir.

Mr. FLIPPO. Sixty-four percent were erroneous penalties; 90 percent of those protested. So if you take 64 percent times 90, that will give you 56, and apparently two thirds of those proved an IRS error.

Mr. SWAIN. That is right.

Mr. FLIPPO. That would then lead you to the conclusion that 37 percent of the respondents, of the errors assessed to the respondents were assessed in error?

Mr. SWAIN. That is a correct interpretation, Mr. Flippo.

Mr. FLIPPO. Now, what I am interested in is when you discussed this with the IRS, did they dispute that?

Mr. SWAIN. I think that their major point of dispute is that we asked taxpayers what they thought, and what taxpayers thought happened is not necessarily what really happened in the eyes of the IRS.

Mr. FLIPPO. OK. So they say then that that is not—because if that is an uncontested figure, I think that is important for us to know. It is a contested figure then, is that correct?

Mr. SWAIN. I am in a difficult situation, Mr. Chairman, because they certainly do not endorse that figure, but they have not brought us any other figures. And short of—I mean, we have done the only thing that we can do. Only the the IRS can do things differently.

Mr. FLIPPO. Well, I just want to—the point I want to make is I am asking you does the IRS agree with this analysis or do they disagree? Is it in dispute?

Mr. SWAIN. I think that they qualitatively agree, but they have not quantitatively endorsed it.

Mr. FLIPPO. In other words, they do not agree with it.

Mr. SWAIN. Not yet.

Mr. FLIPPO. I just wanted to see whether or not they disputed that.

Let me—the timing of the poll, Mr. Swain, was I believe during 1984, 1985, 1986. Can you help us——

Mr. SWAIN. The poll—yes, sir. The poll is actually—the survey was actually done in 1987. And the questions were asked about tax years 1985 and 1986.

Mr. FLIPPO. When the assessments or the penalties would have been——

Mr. SWAIN. That is correct, that is correct.

Mr. FLIPPO. Of course, we have had a great deal of press on the fact that the IRS has experienced a great deal of computer difficulties during that period of time. I am correct then in assuming that your survey was in 1985 and 1986. Now, did they discuss with you in your conversations any improved project, quality control projects, or efforts to—programs that they may have implemented to improve this situation?

In other words, what I'm asking you, are the results of your survey valid in 1988 in terms of is that practice continuing, the 37 percent that your survey says?

Mr. **SWAIN**. The Service has not suggested to us that they believe the record we uncovered or that we purport to have uncovered in 1985 and 1986 is dramatically different today. Most of our discussions with the Service have been along the lines of what they might do administratively from this point forward to improve the current situation.

And as I cannot emphasize enough, I would be more than happy to defer to the more specific and presumably more accurate figures of the Service. But they have not provided any.

Mr. **FLIPPO**. Certainly I would like to see the Service, and I think this committee will be interested in receiving comments from the Service. You raise a very important questions, is this practice prevalent today? Tell us why it is not. Because it is a matter of extreme importance.

But 37 percent is an unacceptable rate, and unless that can be refuted with empirical evidence, it is an intolerable rate.

Now, you make a statement in your testimony too on page 3 at the top that there does not appear to be an effective policy for reducing the number of penalties assessed and abated. Is—would you tell me the basis of that?

Mr. **SWAIN**. Well, the principal basis for that, Mr. Flippo, is the report, specifically the numbers on exhibit 1, which is first chart after the end of the statement. And these are numbers that——

Mr. **FLIPPO**. Well, then your statement then refers to your survey.

Mr. **SWAIN**. No. These are numbers provided by the Commissioner's office. I mean the problem, simply stated, is not improving. The problem is getting worse. So the interpretation that the problem is getting worse leads me to say that there has not yet been effective means taken to improve the problem.

Mr. **FLIPPO**. Well, let me say that the IRS has informed this committee that a number of projects to improve the quality of federal systems have been taken. In the latest Commissioner's annual report, the abatement rates you have used in your testimony have dropped from 36 percent to 14 percent, and in the case of untimely deposit penalties from 25 percent to 16.8 percent overall.

So I think we have a conflict of information. And perhaps we could ask—we want to pursue it because these are very important questions that you raise. And I think we could properly conclude that if we have a 37 percent error rate, 37 percent of the penalties assessed in this area were improper, that that is intolerable. And that if there are no programs to improve that, that is also intolerable.

But I believe that perhaps we could continue this discussion. And we will be asking the IRS for further evaluations in this regard.

Mr. **SWAIN**. If I could just add, Mr. Flippo, I am not for a minute asserting there are no programs to improve it. I am suggesting there could be some further programs. I am confident the IRS is doing something, but we have further——

Mr. **FLIPPO**. Again, I thank you for your testimony, because it is important that you bring us the testimony of the perception of the small business community. And this committee is dedicated to trying to see that improvements are made, that the small business community receives fair and reasonable treatment in the operation of our taxes.

Thank you very much.

Chairman PICKLE. Mr. Swain, before you—oh, Mr. Shaw.

Mr. Shaw, do you have any questions?

Mr. SHAW. Not at this time, sir.

Chairman PICKLE. Mr. Swain, before you leave, I want to make it clear from my standpoint we have 20- and 25-percent abatement errors. The question is are they errors or are they abatements that should be made. I would think the small business would want to have a large number of abatements if they are genuine and that they should be abated.

The fact that there are abatements does not concern me per se. I want to be sure there are errors. You representing the small businesses would want a large number of abatements to be made I would presume. You are asking that they not assessed in the first place due to error?

Mr. SWAIN. That is right, exactly, Mr. Chairman, exactly.

Chairman PICKLE. I think you have got a good point about the number but that they are in error. Now, let me ask you, your report says that sometimes the Internal Revenue receives assets, and even after the taxpayer has successfully communicated the nature of the problem does the SBA threaten to seize these assets often?

Mr. SWAIN. The SBA? We have seized a few assets now and then I am sure.

As you know, Mr. Chairman, the notice procedure is an escalating procedure, and it goes in stages. I am sure the computers are programmed that if there is no apparent response at some point, it says we are going to seize your assets. That is certainly not the first notice.

All I can say, Mr. Chairman, is when we did the survey we asked the question of timing of the notices versus the resolution of the actual penalty and abatement. And one third of the people responding said that after they resolve their penalty they continue to get these notices. And at some point, some of the notices said seizure.

Chairman PICKLE. What should the IRS do about these notices being sent out two, three, and four times, even after the Internal Revenue Service has been notified of the error? I get a lot of letters to me that we are trying to resolve this question, we talked to somebody out there, and they said they understood it, and we continue to get notices, threats. Is this a regular occurrence?

Mr. SWAIN. I think it is a frequent occurrence, and it seems to me, although I am not a computer expert, that if I call a person and say: "Here is my penalty assessment, I have got a payroll tax cancelled check, it is dated the right date, right amount, and let me bring it to your office and show it to you or send you a copy of it," it ought to be possible for the person on the other end of the phone to punch a hold into the computer and say this guy is going to resolve his issue.

Now, maybe the hold will be up in 10 days—I mean there ought to be something possible to hold further action on it.

Chairman PICKLE. Common sense would say you ought to be able to pump that into the computer and that stops it. But that does not stop it. What we need to find out is why it does not stop it. Because that is harassment otherwise. And it is an error that should not be repeated.

Well, I want to thank you for your testimony. Now, again, we are going to submit additional questions to you. I want specific recommendations from you and from your group, because you are in the field and you know the harassment, the nuisance, and the bother that takes place. And we want to try to improve the system.

We have got 150 of these penalties I guess. Somehow we need to codify them and consolidate them in some other manner. So I want you to give us any further statements you have. And we will be submitting questions to you.

Mr. SHAW. Mr. Chairman, could I ask just one question please?

Chairman PICKLE. Mr. Shaw.

Mr. SHAW. In looking at the pie chart which you submitted with your testimony, Mr. Swain, you of course are talking about employment returns. Do you know of any parallel situation with regard to income tax returns or other type of reporting returns that are filed?

Mr. SWAIN. We surveyed employment tax returns, Mr. Shaw, because those are by definition paid by businesses, either Social Security, their own money or on behalf of the employee with withheld taxes. And I am sure the IRS has statistics on the citations, penalties, and abatements on income tax, some 40 violations, but I do not know what they are. I am no expert on it.

Mr. SCHULZE. Mr. Chairman, perhaps that would be an interesting question to ask the IRS when they finally come in and testify.

Thank you.

Chairman PICKLE. Thank you, Mr. Swain.

Mr. SWAIN. Thank you very much, Mr. Chairman.

Chairman PICKLE. Now, the first panel we have this morning consists of the representatives of the American Bar Association, then Kent Smith, a senior research fellow, representing the American Bar Foundation, and then Gerald Portney representing Peat, Marwick, Main.

Would the representatives of these groups come forward.

Now, the American Bar Association this morning is represented by Michael Saltzman, Charles Muller, and James Merritt. The senior research fellow with the American Bar Foundation, Kent Smith, and Gerald Portney, Esq., representing Peat, Marwick, Main & Co., no longer Mitchell, here in Washington.

Let me ask the American Bar, will each one of you gentlemen have a statement to make, or are you making it for the group, Mr. Saltzman?

Mr. SALTZMAN. No, each one of us will have a statement, Mr. Chairman.

Chairman PICKLE. All right. Each one of you will be limited to 5 minutes then. So, Mr. Saltzman, if you will proceed first.

STATEMENT OF MICHAEL I. SALTZMAN, CHAIRMAN, COMMITTEE ON CIVIL AND CRIMINAL PENALTIES OF THE SECTION OF TAXATION, AMERICAN BAR ASSOCIATION

Mr. SALTZMAN. Thank you, Mr. Chairman, members of the committee. I am the chairman of the ABA tax section committee on civil and criminal penalties. I am appearing here today as a designee of Charles Hull, chairman of the ABA tax section.

In the summer of 1987 the tax section appointed a task force to study the Internal Revenue Code penalty provisions. We prepared a report, which we supplied to the committee, and that report of about 120 pages is prepared from the standpoint of practicing lawyers who have experience in representing taxpayers in the administrative processing of civil penalty cases and the trial of those cases in courts when it is necessary.

The report that we have prepared is divided into four parts basically. In the first part we attempted to articulate some criteria which should be applied in the legislation of penalties, in the adoption of penalties, in the adoption of penalty provisions. And then we divided our discussion into the categories of civil penalties that exist. And those civil penalties can be roughly divided into the categories of penalties on taxpayers themselves, penalties on third parties, and information return penalties.

We concluded that several criteria should apply to tax penalties. For example, there are now more than 150 penalties that are in the Tax Code. But penalties alone cannot assure compliance. Penalties have an important but a limited role in the tax system. And they best serve their purpose as part of a balanced program ranging from taxpayer audits, collection of tax, to taxpayer education.

Second, we think that penalties should be reasonable in relation to the misconduct that is meant to be punished. Among other things, this means that a taxpayer should not be subject to more than one penalty for the same act of misconduct. This is not the case today under the law. Where a taxpayer penalty is involved the same underpayment can be penalized by a 5-percent negligence penalty increased by a time sensitive or an interest-based increase in that penalty, a substantial understatement penalty of 25 percent, and a delinquency penalty which itself can be 25 percent.

So this pyramiding effect can exist for a single act of misconduct. To avoid pyramiding, we recommend that all penalties be coordinated.

There is a similar situation to pyramiding that takes place where information return penalties are involved. In general no distinction is drawn between an information return that is filed 1 day late, 6 days late, 6 months late. To make the penalty reasonable in relation to the period of delinquency, we recommend that this penalty and others similar to it be graded or stepped to correspond with the period of delinquency.

Third, a penalty statute should leave no doubt about what conduct is prohibited. In other words, the penalty should give warning to taxpayers and to taxpayer advisers alike. A taxpayer cannot be asked to tow the line if the line cannot be identified, cannot be seen.

The substantial understatement penalty I suggest—we suggest illustrates the problem. It uses a term which has become quite controversial, the term "substantial authority." This term was new. It is not defined in the statute. We believe that standards of conduct, even if they are necessarily broad, should be described or defined in the statute itself. They should not be buried in committee reports, and they should not be left to the Internal Revenue Service to interpret as it chooses in the course of its administrative function.

Fair warning also means fair warning about the amount of penalties. At present both the negligence and fraud penalties, for example, have two parts, one part which is quite clear, the percentage of the underpayment whether that underpayment is the entire underpayment or the fault based underpayment. But there is a second part that is interest based. And that part requires the calculation of interest that has run on the fault based portion of the deficiency from the date the return was due until the date the tax is paid.

This is a hidden penalty raiser. And someone who wants to know the amount of the penalty cannot easily determine that amount. In fact, nowadays there is a kind of growth industry in software packages to determine the amount of interest that is due on federal taxes because they are adjusted periodically.

We have recommended, therefore, that the penalty rate be clearly identified. Now this does not mean that the penalty should be lower. In fact, we have recommended in some instances that the penalty rate be increased. But at least the rate is identifiable, and can be identified by taxpayers and their advisers.

That means that we recommend in general that these hidden interest-based portions of penalties be eliminated. In that way, we feel that a fair warning can then be given to taxpayers.

We also believe that as a criterion for the penalty structure that penalties should serve some educative function. Taxpayers should be educated to the distinction between good and bad behavior. This can only be done if the penalty will be seen by the public as legitimate. That is, based in reasonably grounded interpretations of what is necessary for tax enforcement purposes. It also means that the standard of conduct must be clearly articulated.

Now today you are going to hear from two other members of the task force. Chad Muller is going to discuss the penalties that are imposed on taxpayers, and Jim Merritt is going to discuss the penalties imposed on third parties. But I am going to discuss one penalty that is a penalty on taxpayers themselves, and that is the negligence penalty.

We have recommended significant changes in the negligence penalty in order to achieve some of the criteria or objectives that I have just articulated. And these are not the only ones that are in the report. The negligence penalty is really a misnomer. The penalty itself actually punishes three different types of behavior; perhaps two, but at least two.

It punishes common law negligence; failure to conform conduct to that that a reasonable person would have or engage in under like circumstances. It punishes also intentional conduct, or reckless conduct. And finally, it punishes failure to make a reasonable attempt to comply with the provisions of the code.

We would change the statute, in order again, to give fair warning and to be simpler, and to create a two-tier penalty. That is to say, a penalty which punishes more severely intentional or reckless conduct than it punishes mere negligent conduct. And just arbitrarily perhaps, taking the penalty system that we have now with a fraud penalty at 75 percent, we would suggest that you could have, for example, an intentional conduct penalty at 50 percent and a common law negligence penalty at something like 25 percent.

We say 25 percent. Why? Right now we have a delinquency penalty which reaches or caps at 25 percent after the 5 months of delinquency. So it would be anomalous to have a delinquency penalty at a higher rate than a negligence penalty, which would seem to involve more egregious conduct. So we think that a stepped penalty, graded with more serious misbehavior punished more seriously, and less serious misbehavior punished less seriously, as an appropriate structure.

This is not new. This is not a new suggestion. There was a task force that reported to the administrative conference in 1975 a very similar structure and a very similar statement of a penalty which would think that—we would suggest that the committee consider.

Chairman PICKLE. Mr. Saltzman, before you continue, I don't have your recommendation with respect to the negligence penalty in your testimony. Do you have that, the percentages and figures that you have referred to, or is that going to be presented by someone else?

Mr. SALTZMAN. We will get that for you.

Mr. MULLER. The recommendations are on page 38 of the report.

Mr. SALTZMAN. We direct your attention to page 38 of the report.

Chairman PICKLE. You have reference to the overall report and not to your testimony? I am looking to see where you might——

Mr. SALTZMAN. I am sorry, Mr. Chairman.

Chairman PICKLE. You have given me more than I have asked for here. All right, go ahead.

Mr. SALTZMAN. Just finishing up really on this negligence penalty. This fair warning point is one that we suggest be given serious consideration. In the negligence penalty, in the context of what I will call the negligence penalty, although it has two different elements to it now.

First, we recommend the elimination of this interest-based portion of the penalty because it is a hidden penalty raiser and it does not give fair warning to taxpayers of how seriously, how heavily they are going to be punished if they engage in an act of misconduct.

Second, we suggest that the penalty be imposed on only the fault-based portion of the penalty. Right now the negligence penalty is imposed on the entire amount of the tax deficiency, both negligence-tainted and non-negligence-tainted. There has been a recent Supreme Court case involving a company which had a $1,000 negligence-tainted portion of a deficiency and a $500,000 inventory adjustment, and the negligence penalty was imposed on the entire amount of the deficiency. And that we think is a wrong kind of a situation to exist.

If somebody engages in an act of misconduct, they should be punished for it. But they should only be punished for the act of misconduct and not for some non-fault-based difference in the amount of tax that is owed.

We also believe that there are a number of presumptions that now have been incorporated in the statute. They create confusion in the litigation of tax cases. They create problems in the administration of tax cases because these penalties with presumptions are automatically imposed by the Service and, therefore, make the taxpayer or put the taxpayer in a position of disproving or proving a negative in the context of his dealings with the Service.

Thank you.

[The statement of Mr. Saltzman and the "Penalties Study Report" follow:]

MICHAEL I. SALTZMAN, CHAIR
COMMITTEE ON CIVIL AND CRIMINAL TAX PENALTIES
SECTION OF TAXATION
AMERICAN BAR ASSOCIATION

Mr. Chairman and Members of the Committee:

INTRODUCTION

I am Michael I. Saltzman, New York, New York Chair of the ABA Tax Section Committee on Civil and Criminal Tax Penalties. I am appearing here today as the designee of Charles Hall, Chair of the ABA Tax Section.

In the summer of 1987, the Tax Section appointed a Task Force, made up of members of several different Section Committees, to study the Internal Revenue Code penalty provisions. In addition a statement of five basic reasons for urging the revision of the penalty provisions and six principles for guiding such a revision were adopted by the Tax Section as its position on the overall problem.

The Task Force Report which we are distributing this morning represents the result of our work over a period of months and contains detailed analysis and suggestions, which are intended to translate the general principles adopted by the Tax Section into more specific suggestions and alternatives.

Neither the Tax Section positions nor the Report have been submitted to or adopted by the House of Delegates of the American Bar Association and hence they do not constitute positions of the overall American Bar Association.

REASONS FOR REVISION OF THE CODE

The Tax Section recommends revision of the Internal Revenue Code for a number of reasons:

1. The present penalty structure is unnecessarily complex and lacks internal coordination.

2. The standards for imposition and abatement of penalties are too numerous and are not clearly defined.

3. The penalties overlap and consequently can pyramid in situations involving a single act of misconduct.

4. The pyramiding of multiple penalties can result in punishment disproportionate to the conduct in question.

5. The present penalty provisions are perceived by many to be unfair.

THE CONTROLLING PRINCIPLES

Among the principles which the Tax Section believes should guide the revision of the penalty provisions are the following:

1. Penalties are appropriate elements of an overall administrative effort to achieve voluntary compliance.

2. To be effective in achieving voluntary compliance, the penalty provisions must be understandable and consistent. This requires that the penalties be relatively simple and logical.

3. The total penalty imposition should be perceived to be fair and reasonable in relation to the particular misconduct.

4. To contribute to a sense of fairness, penalties should be applied, and perceived to be applied, for the purpose of deterring and punishing specific misconduct. Accordingly, penalties should not be considered as an independent source of revenue.

5. Since it is not fair to punish acts done prior to the adoption of the punishment, nor acts deterred by penalties not even in existence when the acts are done, penalties should not be adopted retroactively.

6. Penalties should not be imposed to punish conduct which is proper, reasonable or appropriate.

OUTLINE OF THE REPORT

The report was prepared in four sections. First, the Task Force undertook to set forth the history of the penalties and to provide a review of the legal rationale for penalties. The Task Force then divided the penalties into three general categories: penalties imposed on the taxpayer, penalties imposed on third parties, and penalties imposed upon information reporters.

The taxpayer penalties are those which are assessed against a taxpayer for the understatement of his tax liability and for the delinquency in the filing of his return or paying his taxes.

The third party penalties apply to the behavior of others who are not directly liable for the tax. For example, these penalties apply to tax return preparers, individuals who aid and assist in the preparation of false tax returns and promoters of abusive tax shelters. Also considered within this section of the report are penalties which apply to those who file frivolous tax returns and engage in frivolous tax litigation.

The final section of the report concerns information penalties. These are the penalties which encourage information reporters, such as banks and others, to timely file the required information returns.

OVERALL PHILOSOPHY

The report is prepared from the point of view of practicing lawyers with experience in the administration, imposition administrative review and judicial review of civil penalties. We have attempted to describe the basic penalties and, based on our experience as practicing lawyers, describe whether and why certain penalties should be changed or eliminated.

Section of Taxation
American Bar Association

PENALTIES STUDY REPORT

This report was prepared by the Penalties Task Force of the Section of Taxation of the American Bar Association and reflects the general principles as to penalties adopted by the Section. Neither the report nor the principles have been approved by the House of Delegates or the Board of Governors of the American Bar Association, and should not be construed as representing the position of the American Bar Association.

July 28, 1988

PENALTIES STUDY
REPORT
COMMITTEE ON CIVIL AND CRIMINAL PENALTIES
COMMITTEE ON ADMINISTRATIVE PRACTICE

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Page

POSITIONS OF THE SECTION OF TAXATION OF THE AMERICAN BAR ASSOCIATION WITH RESPECT TO TAX PENALTIES 2

BACKGROUND OF TASK FORCE REPORT 2

I. INTRODUCTION 4

- A. The Legal Rationale For Civil Penalties 4
- B. Description Of The Problem 6
  - 1. Cumulation 7
  - 2. Complexity 7
  - 3. Appropriateness 7
- C. Criteria For Penalties 7

II. PENALTIES ON TAXPAYERS 9

- A. Overview 9
  - (i) History of the Income Tax Penalties and Interest Provisions 11
- B. Fraud Penalty 14
  - 1. Present Law 14
  - 2. Discussion 14
  - 3. Recommendations 16
- C. Negligence Penalty 16
  - 1. Present Law 16
  - 2. Discussion 17
  - 3. Recommendations 20
- D. Substantial Understatement Penalty 21
  - 1. Present Law 21
  - 2. Discussion 21
  - 3. Recommendations 24
  - 4. Modifications to Section 6661 If It Is Retained (Dissenting View) 25
- E. Valuation Penalties 26
  - 1. Present Law 26
  - 2. Discussion 26
  - 3. Recommendations 28

Page

F. The Delinquency Penalty 28
  1. Present Law 28
  2. Discussion 29
  3. Recommendations 30
G. Interest Components to Penalties and Interest on Penalties 31
  1. Present Law 31
  2. Discussion 31
  3. Recommendations 32
III. THE THIRD PARTY AND BAD CONDUCT CIVIL PENALTIES 32
A. Overview 32
B. Tax Return Preparer Penalties; Sections 6694, 6695 and 6696 33
  1. Present Law 33
    a. Discussion 34
  2. Recommendations 35
C. Abusive Tax Shelter Promoter Penalty; § 6700 35
  1. Present Law 35
  2. Discussion 36
  3. Recommendations 37
D. The Third Party Aiding and Abetting Penalty; Section 6701 38
  1. Present Law 38
  2. Discussion 39
  3. Recommendations 41
E. The Frivolous Income Tax Return Penalty; Section 6702 42
  1. Present Law 42
  2. Discussion 42
  3. Recommendation 44
F. Frivolous Tax Court Proceedings Penalty; Section 6673 44
  1. Present Law 44
  2. Discussion 44
  3. Recommendations 45
G. Penalties for Frivolous Litigation in Courts Other Than Tax Court 45

Page

1. Present Law 45
2. Discussion 46
3. Recommendation 46

IV. THE INFORMATION REPORTING PENALTIES 46

A. Overview 46
B. Standardization of Penalty Amounts 49
    1. Present Law 49
    2. Discussion 50
    3. Recommendations 53
C. Waiver Discretion and Standards 53
    1. Present Law 53
    2. Discussion 55
    3. Recommendations 56

Section of Taxation

American Bar Association

PENALTIES STUDY REPORT

This report was prepared by the Penalties Task Force of the Section of Taxation of the American Bar Association and reflects the general principles as to penalties adopted by the Section. Neither the report nor the principles have been approved by the House of Delegates or the Board of Governors of the American Bar Association, and should not be construed as representing the position of the American Bar Association.

July 28, 1988

POSITIONS OF THE SECTION OF TAXATION
OF THE AMERICAN BAR ASSOCIATION
WITH RESPECT TO TAX PENALTIES

(Adopted by Section Council, March 4, 1988)

Reasons for Revision of the Code

The Tax Section recommends revision of the Internal Revenue Code for a number of reasons:

1. The present penalty structure is unnecessarily complex and lacks internal coordination.

2. The standards for imposition and abatement of penalties are too numerous and are not clearly defined.

3. The penalties overlap and consequently can pyramid in situations involving a single act of misconduct.

4. The pyramiding of multiple penalties can result in punishment disproportionate to the conduct in question.

5. The present penalty provisions are perceived by many to be unfair.

The Controlling Principles

Among the principles which the Tax Section believes should guide the revision of the penalty provisions are the following:

1. Penalties are appropriate elements of an overall administrative effort to achieve voluntary compliance.

2. To be effective in achieving voluntary compliance, the penalty provisions must be understandable and consistent. This requires that the penalties be relatively simple and logical.

3. The total penalty imposition should be perceived to be fair and reasonable in relation to the particular misconduct.

4. To contribute to a sense of fairness, penalties should be applied, and perceived to be applied, for the purpose of deterring and punishing specific misconduct. Accordingly, penalties should not be considered as an independent source of revenue.

5. Since it is not fair to punish acts done prior to the adoption of the punishment, nor acts deterred by penalties not even in existence when the acts are done, penalties should not be adopted retroactively.

6. Penalties should not be imposed to punish conduct which is proper, reasonable or appropriate.

BACKGROUND OF TASK FORCE REPORT

This report was prepared by a Task Force of the Section of Taxation consisting of members of the Sections' Committees on Civil and Criminal Tax Penalties, Administrative Practice Committees on Civil and Criminal Tax Penalties, and Administrative Practice and Court Procedures. Members of the Estate and Gift Tax Committee also contributed to portions of the report.

The Task Force was chaired by C. J. "Chad" Muller, subchairs include Alison E. Clapp, Claire Fallon, James E. Merritt and Jordan Mintz. Michael I. Saltzman, Chairman of the ABA Tax Section Committee on Civil and Criminal Tax Penalties, and Farley P. Katz edited and revised the report extensively. Ronald D. Aucutt, Thomas G. Bost, Karin Armen Brandys, David R. Brennan, Hugh Calkins, Melvin A. Coffee, N. Jerold Cohen, Gershin Cowen, Michael C. Durst, Curtis Elliot, Peter L. Faber, Marvin J. Garbis, Kenneth W. Gideon, Gersham Goldstein, Charles Hall, Ed Hawkins, K. J. Holdsworth, Phil Mann, Maureen Nelson, John S. Nolan, Marjorie A. O'Connell, David F. P. O'Connor, John C. Richardson, Eugene Sayer, Jasper G. Taylor, III, and Thomas D. Terry, also contributed importantly to the final product.

PENALTIES STUDY

REPORT

COMMITTEE ON CIVIL AND CRIMINAL PENALTIES

COMMITTEE ON ADMINISTRATIVE PRACTICE

* * * *

I. INTRODUCTION

The purpose of this report is to review the civil penalties in the Internal Revenue Code of 1986. It is not possible nor is it our intention to cover in detail each of the civil penalties. It is also not our intention to present a fully redesigned penalty system that is calculated to foster higher degrees of compliance. This report is prepared from the point of view of practicing lawyers with experience in the administrative imposition, administrative review and judicial review of civil penalties. We make no claim to have either the expertise or the data to present a proposed penalty structure that is based on a demonstrable theory of what makes taxpayers comply or not comply with the tax laws. We have attempted to describe the basic penalties and, based on our experience as practicing lawyers, describe whether and why certain penalties should be changed or eliminated.

We have also been requested by the Internal Revenue Service to articulate a rationale for the penalty system in order to establish guidelines against which the adequacy of the existing system can be measured, and a modified system can be proposed.

For purposes of this report, we have categorized and grouped penalties in a manner particularly conducive to analysis of the integration and appropriateness issues. The categories considered are: First, the "taxpayer penalties," i.e., those which apply to understatement of tax and/or delinquent filing of return or payment of tax by the taxpayer himself. These penalties include the delinquency, fraud, negligence, substantial understatements and valuation penalties. Interest is also included in this grouping as it affects the total imposition of the penalty and must be considered in determining the appropriateness of the total sanction in any particular situation. The second category is those penalties imposed upon third parties for conduct which defeats the orderly administration of the tax system. The final category is the penalties involving information reporting.

A. The Legal Rationale For Civil Penalties:

The purpose of penalties as described by the Supreme Court, prior to adoption of the wage withholding and estimated tax systems, still holds true today:

> The United States has relied for the collection of its income tax largely upon the taxpayer's own disclosures. . . this system can function successfully only if those within and near taxable income help and render true accounts. In many ways, taxpayer's neglect or deceit may prejudice the orderly and punctual administration of the system as well as the revenues themselves. Congress has imposed a variety of sanctions for the protection of the system and the revenue.

Spies v. United States, 317 U.S. 492, 495 (1943).

The Supreme Court has also said that since the government relies primarily on the disclosure by the taxpayer of the relevants facts and reported on an annual return, Congress has imposed sanctions "to insure full and honest disclosure, to discourage fraudulent attempts to evade tax. . ." Helvering v. Mitchell, 303 U.S. 391 (1938).

The criminal and civil penalties of the Code reflect this disclosure rationale. Thus, the conduct punished by the evasion statute (Section 7201), the most serious tax felony, is "any conduct, the likely effect of which would be to mislead or to conceal." Spies v. United States, supra. For the same conduct, the fraud penalty statute (Section 6653(b)) imposes the most substantial civil penalty. Similarly, the false statement felony (Section 7206(1)) is imposed when a taxpayer makes a false statement on his return which deprives the Service of the information necessary for it to perform its administrative function. When an underpayment in tax results, depending on the egregiousness of the conduct, the making of a false statement may be punished by the civil fraud penalty (Section 6653(b)), the negligence penalty (Section 6653(a)), or the substantial understatement penalty (Section 6661). Finally, the failure to file a return disclosing information sufficient to permit the Service to perform its function can be punished under the criminal tax penalties as a misdemeanor (Section 7203). Also depending on the egregiousness of the conduct, failure to file can be punished by the civil fraud penalty (Section 6653(b)), by the delinquent filing penalty (Section 6651(a) & (b)), or by other penalties (e.g., Sections 6653(a), 6661).

Penalties also have a remedial purpose that the Supreme Court described many years ago. According to the Supreme Court, civil penalties or additions to the tax "are provided primarily as a safeguard for the protection of the revenue and to reimburse the Government for the heavy expense of investigation and the loss resulting from the taxpayer's fraud." Helvering v. Mitchell, supra. This view was carried over from earlier cases involving the forfeiture of goods or their value in the payment of fixed or variable sums of money as sanctions used since the original revenue law of 1789. In Stockwell v. United States, 80 U.S. (13 Wall.) 531, 547, 551 (1871), the Supreme Court said of a provision that added as addition to the tax double the value of the goods:

> It must therefore be considered as remedial, as providing indemnity for loss. And it is not the less so because the liability of the wrongdoer is measured by double the value of the goods received, concealed or purchased, instead of their single value. The act of abstracting goods illegally imported, receiving, concealing or buying them, interposes difficulties in the way of a government seizure, and impairs, therefore, the value of the government right. It is, then, hardly accurate to say that the only loss the government can sustain from concealing the goods liable to seizure is their single value, or to assert that the liability imposed by the statute of double the value is arbitrary and without reference to indemnification. Double the value may not be more than complete indemnity. ...
>
> ... The act of 1823 was, as we have seen, remedial in its nature. Its purpose was to secure full compensation for interference with the rights of the United States. ...

In short, from the standpoint of lawyers and judges, there are and have been several basic principles underlying the penalty structure. First, a penalty serves to protect the integrity of the tax system. Second, the tax system can only function properly if there is honest disclosure of information and so a civil penalty is a sanction in the form of a money payment imposed to punish a taxpayer for failing to disclose accurate information to the IRS. Third, a civil penalty is a recognized way of reimbursing the government for the expense of investigation and the loss resulting from the taxpayer's nondisclosure or other dishonesty in dealing with his tax obligations.

Other policy reasons for civil penalties have been articulated. Since civil penalties increase the costs of noncompliance, civil penalties are believed to have a deterrent effect on the decision of a taxpayer not to comply with the tax law. See, Administrative Report to Administrative Conference, "Administrative Procedures of the Internal Revenue Service" (October 1975), p. 625 (hereinafter referred to as the Task Force Report). The actual deterrent effect of the civil penalties, however, has been difficult to measure. In 1975, the Administrative Conference Task Force said that the Service had little empirical data to support the rationale that a civil penalty increases the likelihood of compliance because it increases the costs of noncompliance. In 1983, a Tax Section Conference on Income Tax Compliance also found a lack of "satisfactory studies of the actual role and effectiveness of these sanctions." ABA Tax Section, Conference on Income Tax Compliance, p. 217.

Apart from increasing the cost to the taxpayer of noncompliance, civil penalties are said to deter noncompliance by putting in the minds of taxpayers generally the knowledge that other taxpayers are complying or being punished when they do not. Kelley and Oldman, Readings on Income Tax Administration, p. 486.

It is thus frequently assumed that penalties have a deterrent effect, but the data to support the assumption are inconclusive. It is generally accepted, however, that civil penalties supplement other approaches to ensuring tax compliance. For example, an ABA study found, "certainty of detection probably has a greater impact on compliance than does the severity of penalties applied to those who are caught." ABA Commission on Taxpayer Compliance Report and Recommendations Report (July 1987), p. 10.

In summary, there is no one rationale for civil penalties. As a matter of law, civil penalties have been rationalized on the theory that they serve as a form of punishment and a means of reimbursement of the government's costs of investigation. As a matter of policy, civil penalties have been viewed as a means, albeit not an exclusive one, of deterring other taxpayers from engaging in similar conduct.

B. Description Of The Problem:

In 1975, it was said that the sheer number of penalties (then 64) was "mind-numbing." Task Force Report, p. 623. In retrospect, the penalty structure in 1975 was relatively simple. Successive tax acts in 1981, 1982 and 1984 and 1986 have added so many new penalties and modified existing penalties so substantially that the Internal Revenue Service now has more than 150 penalties it must now administer. Before the Tax Reform Act of 1986, which modified a number of penalties, the Treasury Department reported to the President:

> The penalty provisions under existing law are overly complex and often result in inconsistent treatment of similar violations. Penalties have been added piecemeal to the Code as new filing and reporting requirements have been legislated. The inconsistencies in the present penalty structure undermine horizontal equity among taxpayers and make the penalty provisions difficult to understand and administer.

Treas. Dept. Report entitled "Tax Reform for Fairness, Simplicity and Economic Growth" (General Explanation of Treasury Dept. Proposals), Vol. 2, p. 406 (1984).

Both the proliferation and modification of the penalties, as well as their sheer number, present several basic problems:

1. Cumulation.

Penalties have been added to the Code or existing penalties have been modified without any integrated or coherent plan. For a single instance of noncompliance, therefore, different penalties may apply and accumulate. The result is that the aggregate civil penalty can be greater than the tax itself and certainly far greater than the amount of any civil penalties that have historically been imposed on taxpayers for acts of noncompliance with the revenue laws.

2. Complexity.

Penalties have been arbitrarily added to the Code with different standards of imposition and abatement. One study of the penalties has indicated that there are 13 standards incorporated in the civil penalty structure of the Code. This multiplicity of the standards has added both complexity and confusion to an area of the law that should be clear and unambiguous if it is to serve the purpose of deterring taxpayers from engaging in acts of noncompliance.

3. Appropriateness.

The number of penalties and the heavy financial burden that they impose on taxpayers raise a question about the appropriateness of such a penalty structure as a matter of tax policy. Whatever deterrent effect penalties may have, when penalties are perceived as being overly harsh and not in proportion to the conduct punished, they may well have an effect of producing resistance. The lesson of history is that taxes, including civil penalties, "must not merely be imposed; they must be justly imposed. Their efficient, comprehensive and equitable collection is the foundation of healthy and stable government." Johnson, A History of the English People, p. 47 (1985).

C. Criteria For Penalties.

The study of penalties is the study of standards of conduct. The broad purpose of penalties, civil and criminal, is to make people act in a way society regards as desirable and to prevent them from acting in a way society considers to be undesirable. See La Fave and Scott, Criminal Law, p. 21. Penalties impose punishment for bad conduct, rather than rewards for good conduct, and as a result the operation of most penalties is to prevent the undesirable rather than to encourage the desirable. The theory that penalties make people act appropriately by punishing inappropriate or undesirable conduct is a theory of deterrence. Objective evidence to support the rationale is unclear, or at least difficult to measure because it is likely to be only one of a number of forces that restrain people from violating the law. Hall and Glueck, Criminal Law and

Enforcement, pp. 16-17 (2nd Ed. 1958); see also American Bar Foundation Tax Compliance Research Project, Smith & Kinsey, "Cooperation and Control: Strategies and Tactics for Tax Examination," pp. 27-28. There are nevertheless a number of legal criteria that can be identified as appropriate for the adoption, interpretation and application of penalty statutes:

1. A penalty should reflect its limited force in preventing undesirable behavior.

Penalties are not the only means to prevent conduct that threatens harm to the tax system. ABA Comm. on Taxpayer Compliance, Report, pp. 18-23. It is recognized in the criminal law, for example, that while the magnitude of threatened punishment is clearly a factor in deterring misconduct, it is not so important a consideration as the probability of discovery and punishment. La Fave and Scott, supra, p. 23. Similarly, it has been suggested that examination coverage is an important, and perhaps more important, factor in assuring tax compliance than the imposition of civil penalties. The Staff of the Joint Committee on Taxation has said: "The number of times the IRS contacts taxpayers and the number of returns selected for examination may directly affect the public perception of the risks associated with noncompliance." Joint Comm. Pamphlet on Routes to Better Tax Compliance, Tax Notes, June 27, 1983, p. 1187. Another study has confirmed the "potential importance to Federal revenues of the general deterrent effect of auditing." Dubin, Graetz, and Wilde, "Penny-Wise and Pound-Foolish: New Estimates Of The Impact Of Audits On Revenue," Tax Notes, May 25, 1987, p. 789. Thus, penalties will not guarantee compliance, but will best serve their purpose as part of a balanced program ranging from examination and collection to taxpayer education, to appeals to conscience.

2. A penalty should reflect minimum standards, not ideal conduct.

Penalties aim "more to achieve a minimum standard of conduct than to bring about ideal conduct." La Fave and Scott, supra, p. 21. A penalty that imposes too high a standard will inevitably draw into question its own legitimacy by subjecting a broad segment of taxpayers to punishment.

3. A penalty should establish a certain and not imprecise standard to give a fair warning of what is actually required.

Civil penalties are a species of statutorily-created wrongs termed malum prohibitum that are viewed as not inherently criminal. When a statutorily-created wrong is involved, there should be no doubt as to what conduct is prohibited and individuals should have fair warning. Dickerson, The Interpretation and Application of Statutes, p. 210

4. A penalty statute should give an independent and reasonably complete warning of the prohibited conduct.

The occasion on which a sanction is to be imposed should be reasonably free from doubt. For this reason, a penalty should not depend on legislative materials for the meaning or meanings of statutory terms. It should also not depend on regulation or other administrative pronouncement for the meaning of terms. If certain conduct is to be prohibited, the statute itself should be the source of the standard of conduct.

5. The same misconduct should not be subject to more than one penalty.

If a penalty imposes a sufficient punishment for an act of misconduct, then it should be unnecessary to impose a successive or additional punishment for the same misconduct. Consequently, the statute describing the penalties should be expressly coordinated with other penalties that might apply to the same conduct.

6. A penalty should serve an educational function for the affected taxpayer and taxpayers in general.

If a penalty is imposed, it should be calculated to educate the taxpayer and the public to the distinction between good conduct and the bad conduct punished by the penalty. Obviously this can only be done if the penalty can be seen by the taxpayer and the public as legitimate. This requires that the bad conduct punished by the penalty must be clearly articulated and the penalty reasonably based in sound tax enforcement necessity.

7. The punishment imposed by a penalty should correspond with the seriousness of the threat to the tax system created by the conduct involved.

It is obvious that in a rough way the penalty punishment should "fit the crime." If punishment is excessive, the penalty will serve only as a source of public dissatisfaction if not outright noncompliance. On the other hand, if the punishment is insignificant, the seriousness of the undesirable behavior will be diminished and the deterrent effect of the penalty lost altogether. If the penalty is either too harsh or too insubstantial, the result thus may be that the penalty is not enforced. But a penalty will only serve even its limited purposes if it is a real and not merely an apparent threat.

II. PENALTIES ON TAXPAYERS

A. Overview.

The taxpayer penalties are those penalties, including interest,[1] which can apply to an understatement[2] or a delinquent payment of tax. As such, they are the touchstone for enforcement in the voluntary assessment tax system. The taxpayer penalties arise in three basic circumstances: (1) the understatement of tax in a timely filed tax return, (2) the understatement of tax in a delinquent tax return, and (3) a failure to file a tax return or pay a tax.

The following chart sets forth a more detailed description of the understatement penalties:

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[1] Interest is considered a penalty for purposes of this paper because it is part of the total imposition which deters and penalizes non-compliance and encourages early resolution of tax disputes.

[2] "Understatement" is used in this overview instead of the technical term "underpayment" used in Section 6653(c), upon which several of these penalties are based. "Underpayment" is essentially synonymous with the term "deficiency."

BASIC UNDERSTATEMENT PENALTY COMPONENTS

CODE SECTION	TITLE	DESCRIPTION
§ 6653(b)(1)	Fraud	75% of the portion of the understatement attributable to fraud.
§ 6653(a)(1)	Negligence	5% of the entire understatement for a timely filed return or 5% of the total corrected tax on a late filed/or unfiled tax return.
§ 6661	Substantial Understatement	25% of the understatement attributable to a "substantial understatement."
§ 6659	Overvaluation	Where overstatement of basis or value of an asset results in an understatement of tax of at least $1,000: Overvaluation — Penalty 150-200% — 10% Over 200-250% — 20% Over 250% — 30% Contribution 150% and over — 30%
§ 6651(a)(1)	Failure to File	5% per month, maximum 25%, computed on balance due.
§ 6651(a)(2)	Failure to Pay	0.5% per month, maximum 25%.

INTEREST COMPONENTS OF THE UNDERSTATEMENT PENALTIES

§§ 6601(a), 6621 and 6622	Regular Interest	Short-term Federal rate plus 3 percent, compounded daily, nondeductible.
§ 6653(b)(2)	Fraud Component Based on Interest	Additional amount equal to 50% of the interest on the fraudulent portion of the understatement.
§ 6653(a)(2)	Negligence Component Based on Interest	Additional amount equal to 50% of the interest on the negligent portion of the understatement.
§ 6601(a)(2)(A)	Interest on Penalties in General	Interest on penalties (other than IRC 6651(a)(1), 6659, 6660, and 6661 penalties) will be imposed from the date of notice and demand if not paid within 10 days of notice and demand.

6601(a)(2)(B)	Interest on Certain Penalties	Interest on IRC 6651(a)(1), 6659, 6660 and 6661 penalties will begin on the date the return is required to be filed (including extensions).
§ 6621(c)	Enhanced Interest on Tax Motivated Transactions	The regular interest rate is increased to 120% where underpayment exceed $1,000 as the result of certain tax motivated transactions.

(i) History of the Income Tax Penalties and Interest Provisions.[3]

The income tax law of 1913 provided for a 100 percent addition to tax for a fraudulent return, computed on the entire tax imposed.[4] For "a refusal or neglect, except in cases of sickness or absence" to make a return, there was a 50 percent addition, also based on the entire tax imposed. Sec. 3176, Revised Statutes. Where taxes were unpaid after the due date and for ten days after notice and demand, there was added a 5 percent penalty, plus 12 percent interest from the time the taxes were due "except from the estates of insane, deceased, or insolvent persons." Sec. II, E. There was no provision for interest in the absence of notice and demand, i.e., there was no interest on deficiencies prior to assessment and demand.

The Revenue Act of 1916 carried over the 100 percent addition to tax for fraudulent returns, but provided that the 50 percent addition to tax for failure to file a return would not apply "when a [delinquent] return is voluntarily and without notice from the collector filed . . . and it is shown that the failure to file it was due to a reasonable cause and not willful neglect."[5] Sec. 3176, Revised Statutes. The 5 percent penalty plus 12 percent interest for delinquent taxes was carried over. See Sec. 9(a) and Sec. 14(a).

The present structure of the negligence and fraud penalties originated in the Revenue Act of 1918.[6] That Act replaced the 100 percent fraud penalty (contained in Rev. Stat. 3176) with a 50 percent fraud penalty (contained in the Act), computed only on the deficiency. Sec. 250(b). The failure to file penalty was reduced to 25 percent. Rev. Stat. 3176. The Act imposed, for the first time, an addition to tax of 5 percent of the deficiency where "the understatement is due to negligence on the part of the taxpayer, but without intent to defraud," plus interest at the rate of 12 percent. Sec. 250(b). The Act also provided that "if the return is made in good faith and the understatement of the amount in the return is not due to any fault of the taxpayer, there shall be no penalty because of such understatement." The 5 percent penalty for delinquent taxes, plus 12 percent interest, was carried over. Sec. 250(b) and (e). The delinquency interest applied only when the taxes shown on a return were not paid, and the negligence interest applied to amounts negligently omitted from a return. There was no provision until 1921 for interest on deficiencies other than in cases of negligence.

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[3] This summary is limited to the income tax penalties and interest imposed directly on the taxpayer, and does not include estate, gift or excise taxes or the estimated tax.

[4] See Wilson v. Commissioner, 7 T.C. 395, 398 (1946); Hamby v. Commissioner, 26 BTA 670 (1932). See also Commissioner v. Estate of Leyman, 344 F.2d 763 (6th Cir. 1965), vacated, 383 U.S. 832 (1966). The income tax rates, however, were modest, consisting only of a 1 percent basic tax, plus a graduated additional tax reaching 6 percent for taxable income over $500,000.

[5] The normal tax rate was increased to 2 percent and the maximum additional tax rate was increased to 13 percent (for income over $2 million).

[6] The 1918 Act sharply increased the tax rate structure, raising the normal tax rate for individuals to 12 percent and the maximum surtax to 65 percent (for income over $1 million).

The Revenue Act of 1921 first contained the language imposing the fraud penalty where "any part of the deficiency is due to fraud with intent to evade tax." Similarly, the negligence penalty was imposed where "any part of the deficiency is due to negligence or intentional disregard of authorized rules and regulations with knowledge thereof, but without intent to defraud." Sec. 250(b). The statute provided, for the first time, that there would be 6 percent annual interest on deficiencies. Sec. 250(b). The 5 percent penalty for delinquent taxes plus 12 percent interest was carried over. Sec. 250(e).

The Revenue Act of 1924 eliminated interest where the negligence penalty was imposed.[7] The 5 percent penalty for delinquent taxes was repealed.[8] Interest on taxes owed by "estates of incompetent, deceased, or insolvent persons" was imposed at 6 percent. Secs. 274(f), 275, 276.

No significant changes were made until 1939. The 1939 Code modified the failure to file penalty to provide a penalty of 5 percent for a delinquency of 30 days or less, plus 5 percent for each additional 30 days or part thereof, with a maximum penalty of 25 percent. Sec. 291(a). Negligence and fraud penalties remained the same. Sec. 293., i.e., 5 percent of deficiency for negligence (with no interest) and 50 percent of deficiency for fraud. The interest on deficiencies, unpaid taxes and amounts not paid after notice and demand were all uniformly set at 6 percent annually. Secs. 292(a), 294.

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[7] The legislative history provides as follows:

> Experience has shown that the act or omission by the taxpayer which gives rise to these additions is usually not so serious as to require both an increase in the tax of 5 percent and 1 percent a month interest on this amount from the time the tax was due. Accordingly, the provision of 5 percent addition to the tax has been retained, but the provision for interest at 1 percent a month has been omitted.

H.R. Rep. No. 179, 68th Cong., 1st Sess. (1939-1 Cum. Bull. (Part 2) 241, 259); S. Rep. No. 398, 68th Cong., 1st Sess. (1939-1 Cum. Bull. (Part 2) 266, 287).

[8] The legislative history explains this was done "For reasons similar to those given in connection with [the negligence penalty]." H.R. Rep. No. 179, _supra_ at 259; S. Rep. No. 398, _supra_ at 288.

The 1954 Code retained the maximum 25 percent penalty for failure to file, but provided that the penalty would apply only to the net tax due, and not the entire tax imposed. Sec. 6651. The 1939 Code negligence and fraud penalties were retained, with some modifications. First, interest on deficiencies would be imposed in addition to the negligence penalty. Sec. 6653(a). Second, it was provided that if the fraud penalty was imposed, the delinquency penalty (Section 6651) could not also be imposed. Sec. 6653(d). Finally, the negligence and fraud penalties were tied to the "underpayment," which was defined by the statute. Sec. 6653(c). A single provision covered both interest on deficiencies and unpaid taxes shown on returns which remained at 6 percent. Sec. 6601(a). Interest also accrued, following notice and demand, on unpaid taxes, penalties and additions, but the statute was amended to provide that there would be no interest on interest. Sec. 6601(f).

The Tax Reform Act of 1969 added to Section 6651(a) penalties for failure to pay tax shown on a return (Section 6651(a)(2)) and for failure to pay tax not shown but required to be shown on a return within 10 days of notice and demand (Section 6651(a)(3)). Like the failure to file penalty, these penalties are not imposed if the failure was "due to reasonable cause and not willful neglect."

In 1975, the interest rate on deficiencies, which had been 6 percent since 1921, was changed to a flexible rate adjusted periodically. Secs. 6601, 6621.

In 1981, the frequency of the interest rate adjustments was increased and the rate increased slightly. The valuation overstatement penalty (Section 6659) was enacted and the 5 percent negligence penalty was increased by adding a component equal to 50 percent of the interest on the portion of the underpayment attributable to negligence. Sec. 6653(a).

In 1982 (TEFRA), a 10 percent substantial understatement penalty (Section 6661) was enacted, and the 50 percent fraud penalty was increased by adding a component equal to 50 percent of the interest on the imposed portion of the underpayment attributable to fraud. A minimum penalty of $100 was imposed for failure to file a return for over 60 days, even where no tax was owed. Interest rates were compounded daily.

In 1983, Section 6653(h) was enacted providing a rebuttable presumption of negligence where a taxpayer fails to include on his return an item shown as an information return, such as dividends on interest, but limiting the negligence penalty to the underpayment attributable to the omitted item.

In the Tax Reform Act of 1984, the interest rate applicable to "tax motivated transactions" was increased to 120 percent of the regular rate. Section 6621(d). Section 6653(h) was enacted, imposing a rebuttable presumption of negligence for failure to comply with the substantiation rules of Section 274(d). This short-lived provision was repealed the following year.

In 1986, the basic component of the fraud penalty was raised from 50 to 75 percent, but the penalty was limited to the portion of the underpayment attributable to fraud. Where any portion of the underpayment was shown to be fraudulent, a rebuttable presumption was created that the entire underpayment was fraudulent. The negligence penalty was expanded to apply to all taxes under the Code and a statutory definition of negligence was included. The delinquency penalty for failure to pay tax was increased where the IRS has given notice of intent to levy. Differential interest rates for underpayments and overpayments were enacted. The deductibility of interest on tax deficiencies was phased out. The substantial understatement penalty rate was doubled from 10 to 20 percent. The Omnibus Budget Reconciliation Act further increased the rate of the substantial understatement penalty to 25 percent.

B. Fraud Penalty.

1. Present Law.

A civil penalty is imposed on a taxpayer if any portion of an underpayment of tax is due to fraud. Sec. 6653(b). The penalty is equal to 75 percent of the portion of the underpayment attributable to fraud, plus an amount equal to 50 percent of the interest payable on the portion of the underpayment attributable to fraud. Fraud is not defined by the Code. However, the same penalty was imposed under the 1939 Code for fraud with intent to evade tax. The language "with intent to evade tax" was dropped in the 1954 Code, but it has been accepted that the fraud meant is "actual, intentional wrong-doing, and the intent required is the specific purpose to evade a tax believed to be owing." Mitchell v. Commissioner, 118 F.2d 308, 310 (5th Cir. 1941). The Service has the burden of proving fraud, and case law has established that its burden of proof must be carried by clear and convincing evidence. Sec. 7454.

Once the government has carried its burden of proof as to any portion of the underpayment, then both the burden of coming forward with evidence and the burden of persuasion shifts to the taxpayer (who is presumed to have had access to the information) to establish the portion of the underpayment that is not attributable to fraud.

Before the 1986 Act, there were two parts to the fraud penalty. The basic penalty which was equal to 50 percent of the entire underpayment, including both the fraud and non-fraud tainted portions of the underpayment, and an interest-based additional portion of the penalty. This additional penalty is 50 percent of the interest payable on the fraud tainted portion of the underpayment beginning on the return's due date and ending on the date of payment. The 1986 Act increased the penalty rate to 75 percent and limited the portion of the underpayment to which the penalty applied solely to the fraud tainted portion of the underpayment.

If a penalty for fraud is imposed, no negligence penalty may be imposed on the fraud tainted portion of the underpayment. However, a penalty for substantial understatement of tax may be imposed in addition to a fraud penalty. Alternatively, a valuation overstatement penalty may be imposed in addition to a fraud penalty.

2. Discussion.

The presumption established by Section 6653(b)(2) requires that an entire underpayment be presumed to be due to fraud, subject to proof by the taxpayer to the contrary. Thus, once the government establishes that any portion of an underpayment is due to fraud, the taxpayer is liable for a fraud penalty on the entire amount of the underpayment unless he can prove the specific portions of the underpayment not attributable to fraud. The function of a presumption in a civil action is described in Rule 301 of the Federal Rules of Evidence as follows:

> In all civil actions and proceedings not otherwise provided for by an act of congress or by these rules, a presumption imposes on the party against who it is directed the burden of going forward with evidence to rebut or meet the presumption, but does not shift to such party the burden of proof in the sense of risk of nonpersuasion which remains throughout the trial upon the party on whom it was originally cast.

Section 6653(b)(2) thus creates an unusual procedure, by not only shifting the burden of going forward with evidence, but also shifting to the taxpayer the burden of persuasion. Furthermore, it places an especially heavy burden on the taxpayer to prove a negative by clear and convincing evidence.

It is unclear what evidence the taxpayer can and should produce to establish the absence of fraud. Unless pre-trial proceedings identify the items of the deficiency with respect to which the taxpayer will not have to produce evidence, the presumption will create an unreasonable burden of coming forward with evidence on all portions of an underpayment in order to avoid the imposition of the penalty. This burden will fall not only on the taxpayer who has to produce evidence of a high degree of persuasiveness but also on the court which will have to hear this evidence.

Because the negligence penalty which may be asserted on the non-fraud tainted portion of an underpayment is applicable to the entire amount of an underpayment except the portion attributable to fraud, a taxpayer may actually find it more advantageous to concede fraud with regard to an item of income rather than to contest it. Suppose a taxpayer has a deficiency of $25,000, $24,000 of which is attributable to honest mistake or legitimate dispute, and the remaining $1,000 is attributable to omission of dividend income. If the omission of the dividend income were negligent, the basic penalty (ignoring the interest component) would be $1,250 (5% of $25,000), but if the omission were fraudulent, the penalty would only be $750 (75% of $1,000). There thus will be the possibility that a taxpayer may be willing to accept a penalty based on the most serious type of noncompliance in order to pay a lower penalty than he would had the been found liable for the negligent conduct actually involved.

Because of the interest based addition to the basic fraud penalty, it is difficult to predict the amount of the penalty. The interest rate on tax underpayment is now adjusted quarterly, and has been adjusted on semi-annual, annual and biennial bases in the past. Moreover, if the 120 percent interest rate under Section 6621 applies, the interest component of the fraud penalty will be based on that higher rate. See Reg. Sec. 301, 6621-2T, A-6. The computation of the accrued interest therefore is not a simple one and more importantly the amount involved is not readily apparent to the individual whose conduct is to be punished.

An attempt to evade tax can subject an individual to the criminal sanction for tax evasion or the civil fraud penalty or both. The most serious crime is tax evasion, and the most substantial criminal penalty imposed is the one imposed for the violation of the statute. While conduct that violates the evasion statute may also result in the violation of another criminal statute, the courts have generally agreed that only a single punishment will be imposed when a taxpayer is convicted of both charges. The civil fraud penalty is the civil equivalent of the evasion statute, but there is no rule of law that precludes the imposition of a fraud penalty and in addition a penalty for substantial understatement and/or valuation misstatement. Thus, a civil fraud penalty and a substantial understatement penalty can cumulate with the result that the aggregate penalty can exceed 100% of the portion of the underpayment attributable to fraud.

3. Recommendations.

(a) The presumptive fraud provision of Section 6653(b)(2) should be eliminated. The presumption creates an unreasonable burden on the taxpayer and unnecessarily complicates and extends a proceeding regarding the taxpayer's liability. If a taxpayer has understated his tax and the underpayment is attributable to misconduct, the proceedings should be directed to the specific misconduct and not to all the taxpayer's other actions pertaining to his tax reporting.

(b) The penalty for civil fraud should be clear and not indefinite by virtue of the interest based portion of the penalty. The penalty should be a rate imposed on the fraud tainted portion of the underpayment.

(c) There should be no penalty imposed in addition to a fraud penalty for conduct found to be fraudulent. It is as unfair for a taxpayer to be excessively punished by way of civil penalties as it is for him to be punished by cumulative criminal penalties.

C. Negligence Penalty.

1. Present Law.

A taxpayer is subject to a penalty if any part of an underpayment of tax is due to negligence or an intentional disregard of rules and regulations. Negligence is defined to include not only common law negligence but also any failure to make a reasonable attempt to comply with the provisions of the Code, as well as any careless, reckless or intentional disregard of rules and regulations. A statutory presumption provides that if an amount is shown on an information return and the payee or other person with respect to whom the return is made fails to report the amount on the tax return, then the portion of any underpayment attributable to that failure is treated as subject to the negligence penalty. The additional tax attributable to the under reporting is presumed due to negligence unless the taxpayer establishes by clear and convincing evidence that the failure to report was nonnegligent.

The negligence penalty has two components. The first component is an ad valorem penalty of 5 percent of the total amount of the underpayment (except that attributable to fraud). This means that the penalty is imposed both on the negligence tainted portion of the underpayment as well as any nonfraudulent and nonnegligent portion of the underpayment. In addition, the second component of the negligence penalty is equal to 50 percent of the interest that has accrued on the negligence-tainted portion of the underpayment from the due date of the return until the date the penalty is paid.

Under the Code, the fraud penalty is imposed only on the fraud-tainted portion of the underpayment. A negligence penalty may not be imposed in addition to this fraud penalty on that portion of the underpayment. However, if some other part of the underpayment is due to negligence, then the negligence penalty may be imposed with respect to the balance of the underpayment that is not fraud-tainted. Apart from this coordination with the fraud penalty, no other penalty is precluded from being imposed for an underpayment in tax. Thus, a substantial understatement penalty may be imposed along with the negligence penalty as well as a delinquency penalty.

2. Discussion.

The negligence penalty is imposed where three different types of conduct are involved: (1) common law negligence, (2) intentional disregard of rules and regulations, including any careless or reckless disregard, and (3) a failure to make a reasonable attempt to comply with the provisions of the Code. Before the 1986 Act, the penalty included two distinct types of conduct, negligence and intentional disregard of rules and regulations, but there has been some tendency to view the penalty as a penalty for negligence only. In addition, there has been some misunderstanding about the nature of negligence for purposes of the penalty as well as the effect of reliance on a tax advisor.

Common law negligence. Negligence has a meaning outside the tax law which can be and has been applied in tax cases. Negligent conduct is conduct which falls below the standard established by law for protection of others against unreasonable risk of harm, and that standard is that of the reasonable man acting under like circumstances. See Marcello v. Commissioner, 380 F.2d 499, 506 (5th Cir.), cert. denied, 389 U.S. 1044 (1968). The claim that an individual has been guilty of negligence involves two elements: first, that he has done or omitted to do certain things; second, that his conduct does not come up to the legal standard. See, Holmes, The Common Law, p. 122. The trier of fact will resolve any issue about what was done or omitted to be done. The legal standard of the reasonable man is one that is developed from experience--that is to say, over time standards of conduct in like situations develop. Thus, for example, when a standard has developed, the courts have upheld the imposition of a negligence penalty in tax shelter cases. Compare, e.g., Hoelzer v. Commissioner, 43 T.C. 264 (1982) (in a family trust case, the Tax Court warned that a negligence penalty would be imposed in the future) with Ferguson v. Commissioner, 43 T.C. 1317 (1982) (negligence penalty imposed in a family trust case).

As a matter of law, negligence involves both the development and the application of standards to individualized factual situations. Because standards are developed over time and applied to particular facts of specific cases, it is not surprising that in a case involving an allegation of negligence, there may not be a developed standard of conduct to apply or the facts may not warrant the application of a developed standard of conduct. It should not be considered unusual in tax cases for a negligence penalty not to have been imposed, therefore, although it is believed that one should have been imposed. Isolated cases such as ones cited by legislative committees do not indicate a trend or a pattern of a failure of the courts to impose a negligence penalty. See, e.g., Staff Jt. Comm. on Tax, Description of Tax Penalties, p. 15 (Mar. 9, 1988). On the contrary, the cases represent either development of a standard of conduct, the nonapplicability of a developed standard to the particular facts, or the exceptional case.

Reliance on a tax adviser. There has been an uncritical acceptance of the statement that reliance on a competent tax adviser is a defense to a negligence or fraud penalty. Id. This simply is not the law. Reliance on a tax adviser for civil penalty purposes is regarded with the same suspicion that such defense is regarded in the criminal law because the opportunity for collusion is great. Reliance on a legal adviser is related to a taxpayer's mistake of law. Accordingly, it is required that the taxpayer have retained a competent tax adviser, provided that person with all the relevant information and followed his advice. See, e.g., Industrial Valley Bank & Tr. Co. v. Commissioner, 66 T.C. 272, 283 (1976). If the taxpayer has done these things, he has done everything that may reasonably be expected of him for purposes of the tax law. His actions are not a defense as such, but his actions evidence the reasonableness of his belief in the legality of his conduct. In other words, the taxpayer's mistake of law, based on counsel's advice, negatives a mental state required for liability. See, United States v. Boyle, 469 U.S. 241 (1985) ("when an accountant or attorney advises a taxpayer on a matter of tax law, such as whether the liability exists, it is reasonable for the taxpayer to rely on that advice.").

The real inquiry then is whether the taxpayer was at fault for not knowing what the law was. If the taxpayer reasonably relied on advice of the tax adviser, then he has presented evidence that he was not at fault on what is a mistake of law. Under the law as properly understood, therefore, a taxpayer cannot hide behind a lawyer's advice if that advice was based on incomplete information or if the advice was given on only a portion of the elements in a transaction, or even if, under the circumstances, reliance was unreasonable. See, e.g., Betson v. Commissioner, 86-2 USTC ¶ 9712 (9th Cir. 1986) ("Reliance on expert advice is not ... a defense to liability for a negligence penalty if the record reveals circumstances that should have suggested to a taxpayer exercising ordinary care that reliance was unreasonable."); Bilyeu v. Commissioner, T.C. Memo 1988-208 ("reliance must be reasonable, and a blind reliance upon the advice of a purported expert will not constitute a defense."). In the tax shelter area, for example, a taxpayer could not claim reliance on the advice of counsel if that counsel only had opined that the investment entity qualified as a partnership under the tax law, but had expressed no other opinion on the tax consequences of a complicated transaction.

In short, it appears that the impatience with the negligence penalty which gave rise to the valuation penalties and the substantial understatement penalty has been misplaced. There simply is no evidence that taxpayers have, as a matter of law, a greater ability to avoid the negligence penalty than the law properly allows.

Intentional conduct. It is also overlooked that the negligence penalty punishes taxpayers who act intentionally--that is, who intentionally disregard rules and regulations. This aspect of the penalty imposes a different kind of standard on the taxpayers. If a rule of law is settled, then a taxpayer who disregards that rule acts at his peril. It has been accepted by some courts at least that a taxpayer who wishes to contest a tax law or an established rule of law must do so by paying the tax and suing for refund of a portion of the tax claimed to have been overpaid as a consequence of the alleged invalid law. See for example, Druker v. Commissioner, 697 F.2d 46 (2d Cir. 1982), cert. denied. Whether a taxpayer should be required to pay a tax and sue for refund based on a regulation which does not have the force of law is debatable. Regulations which merely interpret law are entitled to weight, even great weight, but they are not law. Rowan Cos. v. United States, 452 U.S. 247 (1981). Consequently, a negligence penalty is not properly imposed when a taxpayer intentionally fails to follow a regulation on the reasonably stated argument that the regulation is not supported by the statute itself.

The negligence penalty thus imposes objective, although developing, standards of conduct on taxpayers to act in a way that a reasonable taxpayer would in the particular circumstances in order to avoid a risk of a tax underpayment. In addition, the penalty imposes a duty on taxpayers to follow the law or an established rule of law, and punishes them if they intentionally fail to do so.

Presumptive negligence. Section 6653(g) imposes a presumptive negligence penalty. Under the law of evidence, when a designated basic fact or aggregate of facts exists, existence of another fact, called the presumed fact must be assumed in the absence of adequate rebuttal. Maguire, Evidence Common Sense and Common Law, p. 183. In the case of Section 6653(g) it is not clear what the basic fact is. The assumption of the statute is that information reported on an information return is correct and that the return has been filed properly. That information is in the hands of third parties. On the other hand, the basis for the presumption is that the taxpayer is assumed to have access to evidence to rebut the presumption of negligence. This inconsistency raises a question about the legitimacy of the presumption.

Moreover, it is doubtful that the presumption is necessary. The effect of imposing a burden of proof by clear and convincing evidence on the taxpayer once the basic fact has been established is really an indication that the conduct involved is, as a matter of law, a reckless or intentional disregard of the rules and regulations. We believe that courts have not refused to impose a negligence penalty when taxpayers has received an information return setting forth the correct amount of reportable income, and the taxpayer has failed to report that income on a tax return. Courts may be less inclined in specific cases to impose negligence penalties for overstated deductions reflected on returns, but there is no evidence that courts have failed or refused to impose a negligence penalty when a taxpayer has failed to report such income.

Computation. The negligence penalty is imposed on the full amount of the underpayment which, except in the case of a late return, means the full amount of the deficiency. Consequently, under present law, a negligence penalty is imposed on both the fault tainted portion of the deficiency and a portion of the deficiency which has no relationship to any taxpayer fault. The harshness of this result is illustrated by the case of Asphalt Products Co. v. Commissioner, 87-1 USTC ¶ 9341 (S. Ct. 1987), in which an $1,100 negligently claimed deduction resulted in a negligence penalty being imposed on a deficiency of more than $550,000 which was attributable to a non-negligence tainted inventory adjustment. The full implication of this method of computing the negligence is demonstrated by the situation of a late return where a portion of the deficiency is attributable to negligence. If a return is late, the amount of the underpayment includes not only the full amount of the deficiency (both the negligence and non-negligence tainted portions), but the amount of tax reported on the return as well. Sec. 6653(c). Thus, in the case of Asphalt Products, if the company had filed its tax return one day late and on that return it had reported a tax imposed of $1 million, the negligence penalty would be 5 percent of $1,550,000, simply because there was an $1,100 deduction that was negligently claimed on the return. This result is harsh and unreasonably so.

The interest-based component of the negligence penalty creates uncertainty for the same reason as it does in the case of the fraud penalty. A separate calculation of the interest due on the portion of the deficiency attributable to negligence (and determination of the applicability of the 120% rate under Section 6621), is required to be made in order to determine the total amount of the negligence penalty. This calculation cannot be done easily because interest rates on tax underpayment have varied and been adjusted.

3. Recommendations.

a) The negligence penalty should be limited to the portion of the underpayment attributable to negligence. If the negligence penalty is conceded to be a fault-based penalty, then the taxpayer should be punished for his misconduct. The taxpayer's punishment should be based on no less than the underpayment that he has made. There is no legitimate reason why he should be penalized on the basis of additional tax the taxpayer may owe because of nonnegligent reasons, such as a frank difference of opinion about the law or because the taxpayer filed his return late. There has long been a concern about the amount of the negligence penalty. It is more consistent with the criteria we have suggested for the penalty structure, however, to have the penalty imposed on the negligence tainted portion of the underpayment and to raise the rate of the penalty in order to punish the degree of misconduct involved. By having an ad valorem penalty without interest-based additions, taxpayers will be given fair warning as to the amount of the penalty.

b) The negligence penalty should have two rates applicable to different levels of misconduct. One approach is to impose one penalty for negligent underpayment of tax and a higher penalty for reckless or intentional underpayment of tax. This approach was recommended to the Administrative Conference in 1975, and we suggest that it should be considered in amending Section 6653(a). Task Force Report, supra, p. 608. With a fraud penalty of 75 percent the rates for these two types of underpayment penalties could be set at 50 percent to cover reckless or intentional conduct and 25 percent to cover negligent underpayment.

c) The interest-based addition to the penalty should be eliminated. If the basic rates of the penalty are raised to correspond to the types of misconduct involved, there should be no reason to impose an addition to the penalty which is not readily determinable.

d) The presumptive negligence penalty should be eliminated. As explained above, the higher standard of proof required to rebut the presumption of negligence when an information item is omitted from a return is more clearly dealt with by making the omission a type of reckless or intentional underpayment subject to a higher penalty than ordinary negligence.

D. Substantial Understatement Penalty.

1. Present Law.

If a taxpayer understates the correct income tax liability by the greater of 10 percent of the correct tax or $5,000 ($10,000 in the case of corporations), a substantial understatement exists and a penalty is imposed in an amount equal to 25 percent of the understated tax. Sec. 6661. The base for computing the penalty is an understatement in income tax which is defined as the amount by which the correct tax exceeds the amount of tax shown on the tax return. The amount of the understatement, however, is reduced by any portion attributable to an item if (a) the taxpayer had "substantial authority" for the treatment of that item, or (b) in non-tax shelter cases, facts relevant to the tax treatment of the item were adequately disclosed on the return (or a statement attached to it).

The IRS is granted discretion to waive all or part of the substantial understatement penalty if the taxpayer proves that there was reasonable cause for the understatement and that the taxpayer acted in good faith.

The substantial understatement penalty is not coordinated with any other penalty, except that, in determining the amount of the substantial understatement penalty, no account is to be taken of any portion of the substantial understatement on which a valuation overstatement penalty has been imposed. If an overstatement is attributable to a valuation overstatement and a valuation penalty has been imposed, the substantial understatement penalty would not be imposed on the same portion of the understatement. Sec. 6661(b)(3).

2. Discussion.

Using the statutory provisions themselves as a guide, the substantial understatement penalty deals with several different types of conduct. It imposes an additional penalty on taxpayers who understate tax on the assumption that these taxpayers have done so because of the relatively few returns examined by the IRS. The penalty attempts to impose a new standard of taxpayer reporting. It also establishes the desirability of disclosing debatable return positions to the IRS. Finally, it is another penalty on taxpayers who claim deductions and credits from tax shelter activities.

At the simplest level the penalty imposed increases the cost of a tax understatement by imposing a substantial penalty (only the fraud penalty has a greater rate) on the amount of the understated tax. The penalty applies automatically when the understatement meets the mathematical requisites for a "substantial understatement." If the understatement is attributable to the omission of an item of income, for example, the penalty applies even if the taxpayer can show that he made a reasonable attempt to comply with the law and that his conduct was not careless, reckless or an intentional disregard of rules and regulations.

If the analysis is stopped at this point, it can be seen that the penalty punishes a taxpayer simply for understating the tax on an income tax return by an amount the law establishes to be substantial. No conduct or misconduct of the taxpayer is relevant unless and until the taxpayer seeks a waiver of the penalty. In this event, the taxpayer must establish both that there was reasonable cause for the understatement and that he acted in good faith. But, as has been indicated above with respect to the negligence penalty, if a taxpayer has done everything that may reasonably be expected of him, he is not negligent and would not be subject to a negligence penalty. Consequently the waiver provision of the substantial understatement penalty and the negligence standard of the negligence penalty overlap or merge in dealing with the conduct of the taxpayer.

The "substantial authority" and disclosure provisions of the statute which permit the penalty to be avoided appear to be directed, in part, at the standard of taxpayer reporting. The situation the statute presupposes is an issue of law. The statute requires the taxpayer's position on the law reflected in the return to be grounded in "substantial authority." However, the term "substantial authority" is not defined in the statute, and this is a serious omission in a penalty statute. The only way a taxpayer would be able to know what the term might mean is to have recourse to the committee reports on the statute, as interpreted and modified by Treasury regulations.

It is unsatisfactory, as stated in our criteria for civil penalties, for the statute itself not to independently give a description of the occasion on which the sanction will be imposed. A taxpayer and lawyer alike should not have to depend on legislative materials in order to discover what a statutory term may mean. When the statutory reference to substantial authority is undefined in any way, it simply does not give a taxpayer fair warning of the kind of conduct expected of him if a taxpayer is to avoid penalty. See Dickerson, supra, at p. 210.

It is said that the disclosure provision of the substantial understatement penalty is being utilized especially by large corporations and taxpayers with sophisticated tax advisers. The use of this simple expedient of disclosure is attractive to lawyers precisely because of the uncertainty of the meaning of substantial authority created by the lack of statutory definition. Whatever the merits of disclosure, those merits are enhanced by the uncertainty of the other basis for avoiding the penalty--that is, substantial authority.

Where taxpayer conduct is involved, the purpose of the term "substantial authority" is unclear. The term again seems to merge or overlap with the negligence penalty in that an intentional disregard of rules and regulations would seem also to constitute an absence of substantial authority. The standard of "intentional disregard of rules and regulations" is clearer in describing what basis in existing law the taxpayer must have for a return position. The uncertainty of the statutory language is clarified only partially by the administrative waiver provision which allows the IRS to waive the penalty provided that the taxpayer establishes that he had reasonable cause and acted in good faith. The regulations indicate that a taxpayer's mistake of law might be a basis for waiver (Reg. Sec. 1.6661-6), and it is fair to say that a mistake of law made in good faith would avoid as well imposition of the negligence penalty for intentional disregard of rules and regulations.

There is some authority in the negligence penalty area that the failure to consult a competent tax adviser is evidence of negligence given the complexity of the tax laws. Cooper v. Commissioner, 542 F.2d 599 (2d Cir. 1976). The assistance of a tax adviser also seems to be assumed for purposes of the substantial authority standard. This is so because whatever substantial authority means it assumes that someone is considering legal authorities and ultimately determining that the authority in support of a position is substantial. In this sense, although the penalty is imposed on taxpayers, the substantial authority standard seems directed at the standard of return preparation by return preparers. Here again, the standard is unsatisfactory because it is not defined in the statute itself. Resort to legislative materials also has proven unsatisfactory because these legislative materials require an analysis that is at the same time unclear, complex and perhaps impossible to make as a practical matter.

The legislative history relating to the substantial understatement penalty lists the type of authority that a tax adviser could consider in determining whether a position was well founded in law. The regulations have further refined the list. Reg. Sec. 1.6661-3(b)(2). But the description of the acceptable authority is not satisfactory because practitioners use information in their practices which either are not included in the legislative history list or are specifically excluded in the regulations. There is dissatisfaction, for example, with the exclusion of letter rulings from the list of "acceptable" authority when practitioners would consider a letter ruling in predicting what the Service position would be on particular issue. It is especially difficult to justify this exclusion when IRS personnel themselves use letter rulings in developing positions for other rulings or positions they may take. The Supreme Court itself has considered letter rulings in arriving at its decision in a case. Rowan Cos. v. United States, supra. Consequently, the legislative context and the administrative interpretation of the undefined term "substantial authority" is unsatisfactory because it varies from legitimate practice of practitioners.

The "substantial" part of the substantial authority is both complex and perhaps impossible to predict. The term is not defined in the statute, and the committee reports presuppose a "higher" basis than "a reasonable basis." Conf. Rep. No. 760, 97th Cong., 2d Sess. 575 (1982). Just what "reasonable basis" means would require a knowledge of issues debated and positions adopted by the ABA, its Tax Section, and the AICPA as well. The reasonable basis standard referred to was an ethical guideline used by both the American Bar Association (ABA Opinion 314) and the American Institute of Certified Public Accountants. The reasonable basis standard was believed by some members of the ABA's Tax Section to be inadequate to guide lawyers in connection with the preparation of tax returns because it did not impose a high enough standard for return preparation. At the same time that Congress was considering the enactment of the substantial understatement penalty, the Tax Section was reevaluating the reasonable basis standard. In 1985, the reevaluation process led ultimately to the adoption of different terminology to describe the standard of practice expected of lawyers. Under this revised standard (Formal Opinion 85-352) a lawyer will be considered to act ethically if in advising a client on a position there is a "realistic possibility of success" for the acceptance of that position in a court of law. This standard has also been criticized. The situation insofar as return preparers are concerned is further confused by the fact that regulations interpreting the penalties on return preparers themselves adopt a "reasonable basis" standard. See Reg. Sec. 1.6694-1(a)(4).

At the present time, therefore, there are several standards which govern or purport to govern the standard of return preparation by tax advisers. Of these standards, the substantial authority standard appears to require the most refined analysis of the outcome of a hypothetical case in court. Thus, the committee reports indicate that a position supported by substantial authority will be "less stringent than a 'more likely than not standard' and more stringent than a 'reasonable basis' standard." If probability of success would mean a greater than 50 percent chance of success in court, then a return preparer is left with attempting to calculate the odds on some lesser chance of success. Trial lawyers cannot calculate chances of success on such a refined basis. It follows that, as a practical matter, tax lawyers who may not try cases at all would have difficulty in applying such a standard. A standard of conduct that cannot even be ascertained simply is inappropriate to use in imposing a penalty.

Coordination. The substantial understatement penalty is only coordinated with the penalty imposed by Section 6659 for valuation overstatements. The penalty is not coordinated at all where both the negligence and fraud penalties apply or with respect to the delinquency penalty. This permits the substantial understatement penalty to pyramid with these other penalties and increase the total penalty involved for a single act of misconduct which may be negligent or fraudulent.

3. Recommendations.

a) The substantial understatement penalty should be eliminated and the intentional failure of a taxpayer to follow rules and regulations punished under the increased negligence penalty described above. The disclosure provision of the substantial understatement penalty can be incorporated in the negligence or underpayment penalty. Elimination of the substantial understatement penalty seems radical; however, the penalty has, with the exception of its disclosure provision, provoked dissatisfaction because of the uncertainty of the substantial authority standard and the lack of coordination with other penalties. There are serious flaws, as we have suggested, with the substantial understatement penalty because it fails to include a definition of substantial authority. It also seems to have been adopted by Congress based on an incomplete, inadequate or misconceived notion of the application of the negligence penalty and its suitability to deal with taxpayers who purportedly relied on advice from tax advisers. The approach of increasing the amount of what is loosely called the negligence penalty to deal with both intentional or reckless acts of misconduct and negligence is a preferable way to increase the penalty on those forms of misconduct. It is certainly far more preferable than to create an unrelated and uncoordinated penalty which effectively punishes similar conduct by adding another penalty to the underpayment in tax. The disclosure provision of the substantial understatement penalty has seemed to work in the area of uncertain applications of law. Accordingly, it is appropriate to consider the use of the disclosure provision in a negligence/reckless conduct penalty.

b) If the substantial understatement penalty is not eliminated, it should be coordinated with the other penalties. Accordingly, we recommend that the substantial understatement penalty be amended to exclude from its application any portion of an understatement which has already been subjected to a fraud, negligence or delinquency penalty.

c) If the substantial understatement penalty is not eliminated, the statutory term "substantial authority" should be defined in a way which gives fair warning to those to whom it was meant to apply and to be consistent with legitimate tax practice by, for example, not excluding the kinds of information that tax practitioners would use in advising clients.

4. Modifications to Section 6661 If It Is Retained (Dissenting View).

While there is substantial minority sentiment that some form of Section 6661 should be retained, there is virtually unanimous dissatisfaction with the current form of Section 6661. Hence, there are significant areas of agreement concerning desirable modifications to the penalty if it is retained. First, the current penalty is assessed at an inappropriately high rate (25 percent). Were the Task Force's recommendations for a 75 percent fraud, 50 percent intentional conduct, 25 percent negligence penalty rate accepted, a sense of proportionality would suggest that the substantial understatement penalty be levied at a rate no higher than 10 percent. Second, in a post-tax reform environment, there is no need to retain a special rule for tax shelters. Finally, there is agreement that the disclosure exception should be retained.

There is substantial opposition to total repeal of Section 6661. Those who oppose repeal note that if Section 6661 were repealed, the Code would contain no sanction against aggressive positions short of negligence other than deficiency interest. They argue that absent Section 6661 or something like it, there will be little motivation to disclose aggressive positions supported by an opinion of counsel (even if, as discussed above, such a position is not an absolute defense). In short, they view repeal as an invitation to return to the "race to the bottom" in advisor opinions which called forth Congressional action in the first place.

Those who hold this view nonetheless recognize that the Task Force criticisms of the "substantial authority" standard have considerable force. There are several possible legislative responses.

Alternative 1: Broaden "authorities" to include proposed regulations, written determinations such as private rulings, and the "Bluebook."

Alternative 2: Transform Section 6661 into a low rate (probably 5 percent) "no fault" audit charge (not a penalty) and eliminate the current "notch" effect (*i.e.*, charge would be imposed only on the amount of the deficiency which exceeds the greater of $5,000 or 10 percent of correct tax).

Alternative 3: Revise the "substantial authority" standard to make clear that the penalty applies only when the taxpayer lacks "substantial legal authority" for his or her position. In other words, the substantial understatement penalty is not properly addressed when the dispute is factual rather than legal.

E. Valuation Penalties.

1. Present Law.

Section 6659 imposes a penalty with respect to individuals and certain corporations where there is an underpayment of income tax attributable to a valuation overstatement. A valuation overstatement occurs where the value of any property or the adjusted basis of any property claimed on any return is 150 percent or more of the correct amount. The penalty is a percentage of the underpayment attributable to the valuation overstatement. The percentage is a sliding scale tied to the degree of overstatement, starting at 10 percent and increasing to 30 percent. With respect to overstatements of charitable deductions, however, the percentage is a constant 30 percent. For the penalty to apply, the underpayment of tax attributable to the value overstatement must be at least $1,000.

Sections 6659A and 6660 provide similar penalties for (1) overstatement of pension liabilities, and (2) valuation understatement on gift or estate tax returns. The penalties are sliding scales based on the percentage of over or understatement, and range from 10 to 30 percent.

The Secretary has authority to waive these penalties where there was reasonable basis for the valuation claimed on the return and the claim was made in good faith. Essentially, this makes the penalties negligence-type penalties. Unlike Section 6661, however, no regulations have yet been issued elaborating on the standards for waiver of these valuation penalties. Also unlike Section 6661, there is no provision for avoidance of the penalty by disclosure of the relevant facts on the tax return.

2. Discussion.

Valuation of property has been long recognized to be a matter of opinion rather than a precise science. Certainly there are situations of readily marketable securities and other properties as to which values may be easily determined, but those are not the usual or difficult situations. The more difficult cases involve situations in which the historical cost data is largely irrelevant because of time or circumstances and market transactions in comparable properties are few and/or difficult to evaluate. In these circumstances taxpayers and the Service have historically viewed the valuation process as an advocacy process wherein each sought to marshall the factors affecting value most favorable to their interests. This process could easily lead to situations in which the opposing opinions of value varied greatly in excess of the range permitted without imposition of penalties. For example, one parcel of real property was recently valued by the Service at 2X and by the taxpayer (based on extensive appraisals) at 30X.

In this advocacy process toward resolving valuation issues both sides may be relying upon sound valuation principles. The vast differences in opinions of value may result from underlying good faith different opinions of law, e.g., the validity of zoning restraints, or different judgements as to comparable market transactions, authenticity, etc. Valuation cases rarely interest the courts and frequently the parties attempt to resolve such issues by arbitration. Unfortunately no prefiling ruling or arbitration procedure is available, hence, taxpayers and their representatives are required to forego prepayment remedies or risk imposition of penalties.

False opinions of value where there is no good faith attempt to determine value in accordance with sound valuation principles or where overwhelming evidence of value is ignored[9] may warrant imposition of penalties. Adversary positions of value based upon reasonably supportable statements of value do not, however, appear to warrant imposition of penalties. In addition to the inherent difficulty in determining value, the transactions and value are reported upon returns. Thus, there should be no problem arising from failure to disclose. Indeed the Service may require additional forms to be filed to separately report and "flag" any amounts reported based upon an opinion of value.

Although Section 6661 contains a threshold requirement (Section 6661(b)(1)) which restricts imposition of that penalty to situations where the understatement is both large in an absolute sense (over $5,000) and large in a relative sense, considering the taxpayer's income (over 10 percent of the tax imposed), the valuation penalties have only a relatively nominal threshold, applying where the tax underpayment is at least $1,000. That amount seems too low in an absolute sense given the vagaries of appraisal science, and it clearly is inappropriate where it is only a relatively insignificant item on the taxpayer's return.

There is no coordination between these penalties and the fraud and negligence penalties. Thus, where a valuation overstatement as described in Section 6659 is also fraudulent or negligent, the IRS will impose both the fraud (or negligence) penalty as well as the Section 6659 overvaluation penalty. There is, however, coordination between the Section 6659 overvaluation penalty and the Section 6661 substantial understatement penalty. The Section 6661 penalty will not apply to the portion of the valuation on which the Section 6659 overvaluation penalty is imposed. Sec. 6661(b)(3).

The valuation penalties, particularly Section 6659, to date, when coupled with the penal interest provisions of Section 6621(c), also present difficult problems of administration and judicial review. These problems are discussed by Judge Cohen in her opinion in Todd v. Commissioner, 89 T.C. No. 63 (Oct. 1987). Such criticism points out the procedural difficulties of the interest provisions which should be repealed for these and other reasons more fully discussed elsewhere.

The valuation penalties, particularly the Section 6659 penalty when combined with the enhanced interest rate imposed by Section 6621(c) and nondeductibility of interest on tax deficiencies enacted by the Tax Reform Act of 1986 may impose enormous costs for errors in opinions of value. The magnitude of these charges and the automatic manner in which they are imposed, barring waiver (Sections 6659(e) and (f)(2), 6659A(e), 6660(e)), indicate that errors in opinions of value are among the most serious of civil tax offenses. This conclusion appears unwarranted although there has not been any comprehensive study of these penalties.

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[9] An example is a value several times the price at which the property recently was purchased in nonduress circumstances without any intervening developments warranting a great increase in value.

3. Recommendations.

a) It is believed that a broad based negligence penalty or, if retained, an expended substantial understatement penalty would make the penalties in Sections 6659, 6659A and 6660 unnecessary and duplicative under the statutory scheme. Accordingly, the valuation penalties in Sections 6659, 6659A and 6660 should be repealed. The threshold requirements in the expended Section 6661 would also appropriately limit the application of penalties to incorrect valuation situations that are relatively significant in amount.

b) In the alternative, if the valuation penalties are retained, a disclosure provision similar to that under Section 6661 should be incorporated and the threshold for imposition of the penalties should be raised from an underpayment of $1,000 to some greater amount, such as $5,000.

F. The Delinquency Penalty.

1. Present Law.

Penalties for the failure to timely file returns or timely pay tax are contained in Section 6651. For the failure to file tax returns, there is a penalty of 5 percent of the amount of tax required to be shown on the return per month, with a maximum penalty of 25 percent. Sec. 6651(a)(1). In computing the amount of the penalty, however, the base on which the penalty is imposed is reduced by any taxes paid or credits which may be claimed on the return. Sec. 6651(b)(1).

For failure to pay the tax shown on any return, there is a penalty of 1/2 of 1 percent of the amount of such unpaid tax per month, with an aggregate maximum penalty of 25 percent. Secs. 6651(a)(2) and (b)(2).

Finally, where the IRS has determined that a taxpayer owes taxes in addition to those shown on a return (or where the taxpayer has not filed a return and the IRS has determined he is liable for taxes), there is a penalty for failure to pay such taxes within 10 days of the date of notice and demand therefor. The penalty is 1/2 percent of the amount of such unpaid tax per month, with an aggregate penalty of 25 percent. Sec. 6651(a)(3).

Where the IRS has given the taxpayer a notice of intention to levy under Section 6331(d), the penalties for failure to pay tax are increased from 1/2 percent to 1 percent per month. See Sec. 6651(d).

Coordination is provided between the penalties for failure to file and penalties for failure to pay tax. Under Section 6651(c), where in any month the 5 percent failure to file penalty applies as well as the 1/2 or 1 percent failure to pay penalty, the amount of the failure to file penalty is reduced by the amount of the failure to pay penalty. Sec. 6651(c)(1). The result is that for an extended failure to file and pay taxes, the taxpayer would be liable for a maximum penalty of 50 percent.

The penalties for failure to file and failure to pay tax are not imposed where the taxpayer can show that the failure was due to "reasonable cause and not due to willful neglect," thus making the delinquency penalties "negligence-type" penalties.

2. Discussion

The delinquency and fraud penalties are coordinated by Section 6653(d), which provides that where the fraud penalty is imposed, no delinquency penalty will be imposed with respect to the portion of the underpayment that is attributable to fraud.[10] There is, however, no coordination provided between the delinquency penalty, on the one hand, and the negligence and substantial understatement penalties, on the other. Where a return is filed late and also contains an underpayment attributable to negligence, both penalties would apply. In such circumstances, however, the negligence penalty would include an implicit delinquency penalty, resulting in a duplication of the penalties. This occurs because, in computing the negligence penalty, the taxpayer is given credit for the amount of tax shown on the return only where the return is timely filed. For example, if a taxpayer files a delinquent return showing tax of $100,000, but has negligently omitted an item on which the resulting tax is, say, $1,000, then the negligence penalty would be five percent of $101,000 or over $5,000.[11] Moreover, this implicit delinquency penalty is a "no fault" penalty; that is, the taxpayer is denied any credit for the amount of tax shown on a delinquent return, regardless of whether there was any justification for the late filing. In addition, the implicit penalty for delinquency bears no relationship to the extent of the delinquency, but rather the amount of tax shown on the delinquent return is excluded in its entirety, regardless of how late the return is. In returns with large amounts of tax shown, this can result in draconian penalties.

The Tax Court held that the delinquent filing of a correct tax return can itself constitute negligence, and justifies imposition of the negligence penalty as well as the delinquency penalty. See Bagur v. Commissioner, 66 T.C. 817 (1976); Robinson's Dairy, Inc. v. Commissioner, 35 T.C. 601, 608-609 (1961), aff'd, 302 F.2d 42 (10th Cir. 1962). But see Haseltine v. Commissioner, T.C. Memo 1976-278 (suggesting imposition of both penalties would be questionable). In such circumstances, it appears that the underpayment on which the penalty is imposed would be the entire amount of the tax imposed, with no reduction for the tax shown on the delinquent return. Robinson's Dairy, Inc., supra. See also LTR 8527012. This results in further duplication between the negligence and delinquency penalties.

The substantial understatement penalty contains a similar implicit delinquency penalty. As discussed above, although the statutory definition of "understatement" for purposes of Section 6661 gives the taxpayer credit for the amount of taxes shown on the return, without limitation to timely filed returns, the IRS has taken the position that for purposes of computing the understatement the taxpayer will not be given credit for taxes shown on any delinquent returns filed after the taxpayer was contacted by the Service regarding such return. See Reg. Sec. 1.6661-2(d)(2). The effect of this is to impose a penalty equal to 25 percent of the taxpayer's total tax liability simply because the taxpayer was delinquent in filing his return. See LTR 8802003. Not only is this duplicative of the Section 6651 delinquency penalties, but it adds a potentially huge additional penalty, the amount of which bears no relationship to the length of delinquency.

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[10] Although the amount of tax shown on a delinquent and fraudulent return is disregarded in computing the amount of the "underpayment," the limitation of the fraud penalty to the fraudulent portion of the underpayment might mitigate the delinquency penalty inherent in the fraud penalty.

[11] Plus the interest component of the penalty.

Although filing a return untimely may well be a negligent act, the delinquency penalty contained in Section 6651 has historically been viewed as the proper sanction for that conduct and, since the delinquency penalty can reach 50 percent of the taxes due, would appear to be an adequate disincentive to the late filing of returns and payment of tax. Applying the negligence penalty to such conduct would be duplicative of the delinquency penalty and be capricious and arbitrary by imposing an additional penalty bearing no relationship to the length of delinquency. For the same reason it would not appear necessary to apply the substantial understatement penalty simply for the delinquent filing of a return.

There is, however, one situation where the delinquency penalty would not appear to be an adequate sanction for the taxpayer's conduct. That is where the taxpayer's failure to file his return was itself fraudulent. In that case, if the taxpayer subsequently filed a delinquent but correct return, the fraud penalty should still be imposed, which would require that the amount of tax shown on the delinquent return be treated as zero.

3. Recommendations.

a) In computing the negligence and substantial understatement penalty, no penalty should be imposed solely with respect to a delinquent filing of a return. A taxpayer thus should be given credit for the amount of tax shown on the return, even if it is delinquent. Thus, if a return is filed late, but the return is correct, the taxpayer's only penalty would (in absence of fraud) be the delinquency penalty; no negligence or substantial underpayment penalty would apply. If a return is filed late but the return negligently understates the amount of tax, the delinquency penalty should be imposed with respect to the delay in filing and the negligence (or substantial understatement) penalty should be imposed with respect to the understatement on the return, giving the taxpayer credit for the full amount of tax that is shown on the (delinquent) return. However, where the Government could show that the failure to file was attributable not merely to negligence, but to fraud as in a Spies-type evasion case, the amount of tax shown on any return filed after the taxpayer was contacted by the Government should not be taken into consideration in computing the underpayment. In that event the fraud penalty (at 75 percent of the total tax imposed) would be imposed, in lieu of the other penalties.

G. Interest Components to Penalties and Interest on Penalties.

1. Present Law.

There are several new interest provisions which increase the total monetary imposition on a taxpayer for the underpayment of tax. The regular interest imposition on any underpayment of tax is the short term Federal rate determined under Section 6621(b) plus three percentage points. Sec. 6621(a)(2). This interest rate is compounded daily. Sec. 6622. The interest is computed on the underpayment from the last date prescribed for payment, usually the due date of the tax return, without any extensions. Sec. 6601(b). The interest runs to the date of payment. Sec. 6601(a).

Section 6621 also provides for a differential between interest due a taxpayer upon overpayment and that due by a taxpayer to the government based upon an underpayment. In the case of a refund, the government pays the taxpayer the short term Federal rate plus two percentage points. Sec. 6621(a). In the case of an underpayment, the taxpayer must pay the short term Federal rate plus three percentage points. Sec. 6621(a)(2).

The interest paid by the individual taxpayer on an underpayment of tax is nondeductible personal interest. Sec. 163(h)(2).

The Code also provides for interest on penalties in certain circumstances. Regular interest due on underpayments is imposed on most penalties only after ten days from the date of notice and demand. However, with respect to the failure to file penalty (Section 6651(a)(1)) and the valuation penalty (Sections 6659, 6659A, 6660), interest on the penalty runs from the due date of the tax return to the date of payment.

In addition, the interest rate is increased to 120 percent where the underpayment of tax exceeds $1,000 as the result of a "tax motivated transaction." Sec. 6621(c). Tax motivated transactions include valuation overstatements under Section 6659, and sham or fraudulent transactions.

Present law also provides for an interest component to the negligence and fraud penalties. Those components are 50 percent of the regular interest payable on the portion of the underpayment attributable to negligence or fraud, computed from the due date for payment of the tax. Under the Technical Corrections Bill, these interest components to the fraud and negligence penalty would be repealed, and in lieu of those provisions, interest on the fraud and negligence penalty would be computed in the same manner described above for the failure to file and valuation penalties; that is, interest would accrue from the due date of the tax return.

2. Discussion.

The penalty system should be as simple as possible. For this reason, the basic penalty rates should be set at amounts sufficient to obtain the required compliance goals. An adequate penalty rate, when coupled with market interest, is believed to be sufficient to obtain the desired results without unnecessary complexity.

Although the interest paid on a tax deficiency is not technically a penalty, taxpayers are likely to consider the total additions to tax and interest as having a punitive intent. In that context, higher interest charges on deficiencies than is paid on refunds combined with the fact that interest paid is non-deductible where interest received is taxable, may be considered not only punitive but unfairly punitive. Moreover, the charging of a higher interest rate by the IRS than it pays is perceived as inherently unfair. For these reasons, it is proposed that there should be no interest differential between refunds and deficiency payments.

Finally, the various interest components of the basic penalties and interest enhancement provisions should be eliminated. Adequate sanctions for fraud and negligence should be reflected in the basic penalty rates. Section 6601 should also be amended to provide that interest on all penalties runs from 10 days after the date of notice and demand. Thus the combination of regular interest on the tax and interest on the penalties should be at rates sufficiently time sensitive to deter understatements of tax and to encourage early resolution of tax controversy regardless of the underlying culpability of the taxpayer.

3. Recommendations.

a) The interest components of the fraud and negligence penalties should be repealed.

b) Enhanced interest on tax motivated transactions should also be repealed.

c) There should be no interest differential between or amounts due to the taxpayer as refunds and on taxes owed by the taxpayer.

III. THE THIRD PARTY AND BAD CONDUCT CIVIL PENALTIES

A. Overview.

Beginning in 1976, Congress enacted a series of penalties designed to address specific compliance problems which it was believed were not adequately addressed by existing civil and criminal sanctions.[12] These penalties address diverse actions by third parties and taxpayers which took advantage of the absence of any sanctions applicable to such actions and the difficulty, if not impossibility, of applying traditional civil and criminal fraud and negligence or intentional disregard penalties. These penalties include penalties designed expressly to apply to tax return preparers and advisors (Sections 6694, 6695 and 6696); promoters of abusive tax shelters, including principals, advisers and sales personnel (Section 6700); any person, including nontax corporate employees, who aids and abets an understatement of tax liability (Section 6701); and taxpayers who file frivolous returns (Section 6702); or prosecute frivolous Tax Court proceedings (Section 6673), referred to as "tax protester" penalties. In addition, special partial payment refund procedures were created for certain of these penalties. Sections 6694(c), 6696 and 6703. In addition to the civil penalties, the Service has been granted express authority to enjoin tax return preparers (Section 7407), and promoters of abusive tax shelters and aiders and abettors (Section 7408). Moreover, as to both tax return preparers and tax shelters reporting and registration requirements are imposed to permit the Service to identify the employees of preparers and promoters as well as their customers and investors.

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[12] Section 6673 provided for many years that the Tax Court could impose a penalty upon a taxpayer who instituted or maintained a Tax Court proceeding primarily for delay. This provision was, however, amended and expanded in 1984 and 1986.

B. Tax Return Preparer Penalties; Sections 6694, 6695 and 6696.

1. Present Law.

In 1976 Congress enacted civil penalties specifically applicable to tax return preparers as well as information reporting and identification requirements and granted the Service authority to enjoin violations of these requirements or to bar practice as a tax return preparer. The amount of the civil penalties is minor: $100 per return for an understatement of tax liability due to the negligent or intentional disregard of the rules and regulations (Section 6694(a)); $500 per return for a willful attempt to understate tax liability (Section 6694(b)); $25 or $50 for each violation of information requirements subject to return period maximums of $20,000 or $25,000 (Section 6695(a)-(e)); and $500 for negotiation of a refund check (Section 6695(f)). Preparers were also required to file information returns, Section 6060; to furnish a copy of the return to the taxpayer and retain a copy or list (Section 6107); to furnish an identification number (Section 6109(a)(4)); and to sign returns (Section 6695(b)).

Prior to 1980 the Service published little guidance interpreting the return preparer penalties. Imposition of the penalties was delegated and decentralized. As a result, the penalties were not properly applied.[13] The Service waived penalties for 1977 and 1978 and published Revenue Procedure 80-40, 1980-2 C.B. 774, and a series of revenue rulings in 1980. Regulations promulgated under Section 6694 and Revenue Procedure 80-40 provide sufficient guidance to permit return preparers to institute "normal office procedures" which should avoid imposition of the preparer negligence penalty for normal mistakes which may occur in preparing tax returns.[14] For example, one commentator has concluded that "the tax return preparer should never have the embarrassment of having to defend himself against a Section 6694(a) penalty assessed by the IRS." Thomas, "The Negligent Return Preparer: Avoiding Section 6694(a)", 63 Taxes 831, 839 (1985). See also LTR 8218005. Similarly, it appears that the penalties and related educational and enforcement programs have made substantial improvement in compliance. Preparer penalties assessed decreased from 32,088 in fiscal year 1981 to 10,534 in fiscal year 1985.

Although the Service has successfully enjoined tax return preparers, the procedures are not well established in the courts. Preparers have utilized the partial payment refund procedures provided by Congress. Secs. 6694(c), 6996.[15] The courts have interpreted the preparer negligence penalty broadly and disputes may continue to arise regarding the scope of the penalty. Generally, the Service has adopted administrative review procedures which ensure that imposition of the penalties are impartially reviewed and are considered separately from the taxpayer's liability. IRM 4297. Problems have, however, been experienced where the Service failed to follow its administrative procedures and the partial payment refund procedures. These problems do not appear to require new procedures merely compliance with existing procedures.

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[13] "[M]any times penalties were proposed for immaterial items, no consideration was given to so-called 'good faith' disputes and no uniformity of standards existed." Arzoo, "Preparer Penalties and Compliance," The Tax Advisor, 36, 37 (Jan. 1987). Also see Kamerow, "Return Preparer Problems Since the Tax Reform Act of 1976," 39th Annual N.Y.U. Institute, 37-1, 37-14 to 37-15 (1980).

[14] See also Rev. Ruls. 80-262 through 80-266.

a) Discussion.

Duty to Inquire. Tax return preparers are not required to audit information provided by their customers, but when they obtain information which raises questions they must make reasonable inquiries. Reg. Sec. 1.6694-1(b)(2); Rev. Proc. 80-40, Sec. 4.03, 1980-2 C.B. 774, 775. This has been interpreted to apply to information the preparer receives with regard to related parties. Brockhouse v. United States, 749 F.2d 1248 (7th Cir. 1984); Pickering v. United States, 691 F.2d 853 (8th Cir. 1982). A preparer must also consider the results of a prior audit. LTR 8022027.

Definition of "Return Preparer". The Service has issued sufficient advice to resolve definitional problems where multiple preparers are involved and issued written determinations which have provided specific advice to preparers. E.g., Sec. 7701(a)(36); Reg. Secs. 301.7701-15(a), 1.6695; Rev. Ruls. 81-171, 81-241, 81-270; LTR's 8731004, 8035069.

Injunction Proceedings. There have been difficulties in injunction proceedings initiated by the Service. See e.g., United States v. Nordbrock, 828 F.2d 1401 (9th Cir. 1987); Swayze v. United States, 785 F.2d 715 (9th Cir. 1986); and United States v. Ernst & Whinney, 557 F. Supp. 1152 (N.D. Ga. 1983), rev'd, 735 F.2d 1296 (11th Cir. 1984), cert. denied, 105 S. Ct. 1748. It appears that these involve questions of judicial procedure although the Ernst & Whinney case raised questions concerning the bond provisions of Section 7407(c) whereby certain injunction actions may be stayed by posting a bond of $50,000 for payment of possible penalties under Sections 6694 and 6695. The Service, has, however used Section 7407 injunctions successfully in conjunction with coordinated return preparer tax shelter promoter actions. United States v. Savoie, 594 F. Supp. 678 (D. La. 1984); United States v. Hutchinson, 83-1 U.S.T.C. ¶ 9322 (S.D. Calif. 1983).

Injunction authority provides the Service a needed procedure for the return preparer abuses Congress sought to address and it should not be restricted.[16] The Service and Department of Justice, however, should use restraint in exercising that power. The potential for abuse by use of injunctions under Sections 7407 and 7408 requires continued attention to developments in the administrative use of the potent procedures and judicial developments to ensure appropriate discretion is exercised and that when properly invoked the procedures work efficiently.

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[15] The partial payment refund remedy of Sections 6694(c) and 6696 is discussed in the section on the aiding and abetting penalty of Section 6701, infra.

[16] In Ernst & Whinney, the Eleventh Circuit held that the government may also obtain an injunction under the general and long-standing provision of Section 7402(a). The government also argued on appeal, although the court did not reach this point, that the government can obtain an injunction under a court's general equitable powers, without the need for any specific statutory authorization. See, e.g., United States v. LeMay, 322 F.2d 100, 103 (5th Cir. 1963).

Good Faith Challenges to Service Positions. This was an issue of principal concern to practitioners upon enactment of preparer penalties. The substantial understatement penalty has perhaps preempted concern about repressing legitimate disputes regarding interpretation of the tax laws by imposition of penalties. Regulations accurately reflect Congress' intent that the preparer penalties not apply to good faith disputes. Reg. Sec. 1.6694-1(a)(4); and see Rev. Proc. 80-40. Indeed in Section 6694 Congress rejected a mandatory disclosure requirement, but retained the facts and circumstances test of Section 6653(a). General Explanation of the Tax Reform Act of 1976, 484. In advice the Service has made it clear that a preparer must rely upon his own view of the validity of any rule. LTR 7813019.

There continues to be a risk that overzealous application of the preparer penalties will improperly restrict good faith disagreements. Moreover, the interrelationship of the preparer penalties with the substantial understatement penalty is unclear. It is clear, however, that the substantial authority or adequate disclosure requirements of Section 6661 do not apply to Section 6694(a).

Disciplinary Actions. The imposition of preparer penalties results in an automatic referral to the Director of Practice. This is a cause for concern because it does not appear that consideration of disciplinary action should result from imposition of every preparer penalty. Consider the situation in Brockhouse, supra. The interrelationship of civil penalties applicable to practitioners with disciplinary proceedings requires constant review because the principal deterrence effect of these penalties is not the dollar penalty, but the professional disgrace and discipline which may follow imposition of the penalties.

2. Recommendations.

The Committee recommends that the Service continue to review and coordinate assertion of return preparer penalties. Disciplinary review boards which include practitioners should be considered as a means to ensure reasonable imposition of disciplinary action based upon asserted preparer penalties or other factors. Guidance to practitioners via rulings and written determinations should continue and the success of such guidance under Sections 6694 and 6695 should encourage expanded guidance in other areas. Regulations should be issued under related Sections 6700 and 6701 to the extent they may apply to activities which could be subject to the Section 6694 and 6695 penalties.

C. Abusive Tax Shelter Promoter Penalty; Section 6700.

1. Present Law.

The tax shelter promoter penalty, like the return preparer penalties, was accompanied by an express grant of authority to the Service to seek injunctions, Section 7408, as well as penalties for failure to maintain and provide information, Sections 6707 and 6708. The courts have considered both injunctive remedies to be similar. E.g., United States v. Nordbrock, 828 F.2d 1401 (9th Cir. 1987). The Service and the

Department of Justice instituted special examination, review and prosecution teams to implement the tax shelter promoter penalty with a view to utilizing Section 7408 injunctive relief. Rev. Proc. 83-78, 1983-2 C.B. 595, modified by Rev. Proc. 84-84, 1984-2 C.B. 1982; and see Rev. Rul. Sec. 84-175, 1984-2 C.B. 296. Although pre-filing notifications to investors included in procedures adopted by the Service were highly controversial the enforcement program as a whole was highly successful and obtained a significant number of consent injunctions.[17] Of course, Congress has acted to eliminate tax shelters generally in the Tax Reform Act of 1986 and the Service has been largely successful in litigation of tax shelter issues on a test case basis in the courts. Both the statutory amendments and enforcement activities appear to have had a high impact on reducing tax shelters.[18]

The Service has provided less guidance with regard to the tax shelter promoter penalty than for the tax return preparer penalties. The persons who could and did engage in promoting tax shelters, for the most part, were not members of professional groups. Moreover, the activities attacked were considered to be highly abusive and the in terrorem effect of a lack of guidance was apparently considered. Promoters of abusive tax shelters, unlike most tax return preparers, were also viewed as persons attacking the system as compared to preparers who generally sought to comply with the system. To the extent these considerations might not apply to across the board, the Service should consider issuing further guidance. For example, sales persons and other personnel removed from the core promoter group, may well be unaware that their activities could be subject to penalties.

2. Discussion.

Section 6700 provides that a person who makes a false or fraudulent statement or a gross valuation overstatement in connection with certain organizational or sales activities relative to a plan or arrangement of the type described shall pay a penalty "equal to the greater of $1,000 or 20 percent of the gross income derived or to be derived by such person from such activity." Case law interpreting the quoted language is in conflict. In Waltman v. United States, 618 F. Supp. 718 (M.D. Fl. 1985), the court held that the plaintiff was liable for a penalty equal to $1,000 for each sale made by him. The court in Spriggs v. United States, 660 F. Supp. 789 (E.D. Va. 1987), however, held that $1,000 was a minimum penalty to apply to the composite of all organizational and sales activities of the penalized party if 20 percent of the gross income derived or to be derived from those activities was less than $1,000. Section 6700 is totally silent on how long after the fact a penalty assessment may be made. As yet, there is no case law on the question of a limitations period on the assessment or collection of the penalty.

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[17] The pre-filing notification procedures were upheld by the courts in Mid-South Music Corp., 756 F.2d 23 (6th Cir. 1985) and Western Reserve Oil & Gas Co. v. New, 85-2 U.S.T.C. ¶ 9653 (9th Cir. 1985), cert. denied, 106 S.Ct. 795 (1986).

[18] The Service has succeeded in penalty/injunction proceedings. E.g. United States v. United Energy Corp., 87-1 U.S.T.C. ¶ 9216 (N.D. Calif. 1987); United States v. Smith, 657 F. Supp. 646 (D. La. 1987); United States v. Philatellic Leasing Ltd., 794 F.2d 781 (2d Cir. 1986); United States v. Petrelli, 86-1 U.S.T.C. ¶ 9233 (1986); United States v. Music Masters, 621
(Footnote Continued)

Section 6700 requires clarification. Until the method of calculation of the Section 6700 penalty and the applicability of a limitations period are resolved, these issues will be the subject of frequent litigation. Litigation of this type is time consuming and costly. Moreover, differing interpretations of the courts will result in non-uniform application of the penalty and unequal treatment of taxpayers.

3. Recommendations.

a) It is recommended that Section 6700 be amended to provide for imposition of a penalty with respect to each organizational or sales activity engaged in by a promoter or salesman. The penalty for an organizational or sales activity involving a gross valuation overstatement should be $500, a penalty amount comparable to the $500 penalty imposed by Section 6694(b) for willful understatement of tax liability by a tax return preparer. The degree of fault involved in a false or fraudulent statement justifies a $1,000 penalty, an amount comparable to the penalty imposed by Section 6701 for knowingly aiding and assisting the understatement of a third party's liability.

b) There should be a five year limitation on the time for assessing and collecting Section 6700 penalties.

c) Further consideration of the tax shelter enforcement program is warranted including the various civil penalties which may be involved. For example, the government's position in United States v. Turner, 601 F. Supp. 757 (E.D. Wisc. 1985) is troubling. As described in the opinion the government sought to enjoin a person under Section 7408 for alleged Section 6700 gross overvaluations in a situation where the person personally had not made or furnished a valuation overstatement. The government's position was based upon: (1) joint liability as an alleged partner; (2) vicarious liability in the nature of tort liability; and (3) theories of conspiracy or aiding and abetting. The court refused to grant the injunction. This opinion illustrates the potential for overexpansive use of these provisions even though the opinion may simply reflect inadequate pleading.

(Footnote Continued)
F. Supp. 1046 (W.D.N.C. 1985); United States v. Bradbury Independent Mining Co., 85-2 U.S.T.C. ¶ 9757 (1985).

D. The Third Party Aiding and Abetting Penalty; Section 6701.

1. Present Law.

Section 6701 of the Code, enacted as part of TEFRA in 1982, was intended to curb many abuses perceived by Congress in the area of compliance. Section 6701 was intended to be the civil counterpart to the criminal penalties provides by Section 7206(2). Section 7206(2) penalizes those who willfully aid or assist in, procure, counsel or advise the preparation or presentation of a return, affidavit, claim, or other document which is fraudulent or false as to any material matter.

In general, Section 6701 provides for the imposition of a penalty on any person who aids or assists in, procures, or advises with respect to, the preparation or presentation of any portion of a document in connection with any matter arising under the internal revenue laws, who knows that such portion will be used in connection with any material matter arising under such laws and that such portion, if so used, will result in an understatement of the liability for tax of another person. The amount of the penalty is $1,000 ($10,000 for corporate returns) which is subject to a limit of one penalty for each taxpayer per taxable period or event. The conduct sanctioned includes ordering or otherwise causing a subordinate to do an act, and knowing of, and not attempting to prevent, participation by a subordinate in an act. The person whose tax is understated is not required to have consented to or been aware of the understatement, but furnishing certain types of mechanical assistance is not to be considered as conduct which results in imposition of the penalty. The Section 6701 penalty can be imposed in addition to any other penalty, except for the return preparer penalties found in Section 6694(a) and (b).[19]

Section 6701 is directly related to several other statutory provisions. Section 6703 of the Code provides rules applicable to procedural matters, including establishing that the burden of proof is on the government, deficiency procedures will not apply, and judicial review may be obtained by proceeding to federal district court. Section 7408 authorizes injunction proceedings by the government to enjoin conduct penalized under Section 6700 or Section 6701. Sanctions upon administrative practice by appraisers who are penalized under Section 6701 are imposed. 31 U.S.C. Sec. 330.

Section 4563.65 of the Internal Revenue Manual provides (based upon legislative history) that no person will be subject to the penalty unless he is directly involved in aiding or assisting in the preparation or presentation of a false or fraudulent document under the tax laws, so that if a person prepares a portion of a return correctly, that person will not be penalized even if he knows that other portions (which he did not prepare and over which he does not have control) are fraudulent. The Manual also provides in this section that the supervision of a subordinate must be direct and immediate in order to constitute conduct subject to the penalty, but that the term "advises" includes actions of independent contractors such as lawyers and accountants who "counsel a particular course of action".

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[19] The Section 6701 penalty can be assessed upon a tax return preparer for conduct subject to penalty under Section 6694. The Senate would have prohibited application of the Section 6701 penalty where preparer penalties could apply, but this was rejected by the Conference Committee. As a result the Service has the option of assessing the Section 6694 penalties or the Section 6701 penalty.

Section 4563.61 of the Manual provides that examiners will propose the Section 6701 penalty "only in circumstances where they are clearly appropriate." This section of the Manual further provides that to assure uniform treatment of taxpayers in the assertion of penalties, each district director will redesignate the Preparer Penalty Screening Committee to the Penalty Screening Committee, which will review proposed penalty assessments. However, this section of the Manual also provides that if the valuation overstatement penalty is being applied under Section 6659, consideration should be given to asserting the aiding and abetting penalty of Section 6701 on an appraiser whose appraisal was used as a basis for the overstatement.

Section 42(17)(13).2 of the Manual provides that Section 6701, along with other penalties, should be considered, and asserted if appropriate, in cases where parties such as promoters, sales people, attorneys who write tax shelter opinions, appraisers, return preparers, accountants who prepared financial forecasts, and any persons acting in concert therewith (such as manufacturers) are involved.

Finally, Section 4297.9 of the Manual provides that when a tax practitioner's misconduct is serious enough to cause a penalty assessment, there must be a referral to the Director of Practice for consideration of disciplinary proceedings. No regulations have been issued under Section 6701.

2. Discussion.

Overbreadth and Ambiguity. There obviously exists a possibility that the statutory language of Section 6701 is so broad and vague that it could reach conduct which not only is not improper but which is instead exemplary. For example, a client asking for advice on a document to be attached to a tax return might be advised by his professional advisor that the document should not be used, with the advisor having full knowledge that the client intends to attach the document to the return, and that, if used, the document will result in an understatement of liability. The statutory requirements for imposition of the penalty would be met since the advisor has "advised with respect to" the document, knows that it will be used "in connection with the material matter," and knows that the document "if used, will result in an understatement of liability." That obviously is not the intent of the statute, and the Service has recognized a related proposition when providing in the Manual that conduct is not subject to the penalty if the person in question was not directly involved in aiding or assisting in the preparation or presentation of a false or fraudulent document. Further, the criminal statute used as a model for Section 6701 - Section 7206(2)--clearly requires active and affirmative assistance, since the defendant must (when the gravamen of the offense is counsel or advice) have counselled or advised the preparation or presentation of the document.

While the statute provides that conduct resulting in imposition of the penalty will not include the furnishing of typing, reproducing, or other mechanical assistance, it is unclear what types of conduct may constitute "mechanical assistance." For example, advisors may take actions to facilitate the preparation and delivery of a return after a client has been contacted by a revenue officer concerning the return's delinquency. The advisor may engage a preparer, may establish a timetable with the revenue officer, and may otherwise assist in ensuring that the return is prepared and properly filed, without taking any action with respect to the specific contents of the return.

Applicable Standard for Knowledge. One of the requirements for imposition of the penalty is that the person "know" that the portion of the document in question "will result in an understatement of the liability for tax of another person." Obviously, there are many definitions of "knowledge," including knowledge beyond a reasonable doubt, more likely than not, possible, etc. There is also a possibility that constructive knowledge may be involved, since knowledge is often defined to include that which would have been known by the exercise of due diligence. See Sec. 6323(i)(1). While it is comforting that the Service is directing examiners not to seek imposition of the penalty unless "it is clearly appropriate", there still exists a very serious lack of direction as to the type of knowledge which will result in imposition of the penalty.

Unreasonably Cumulative. The Code is replete with penalties which can be imposed on third parties for conduct which could result in the understatement of liability for some other person, and the Section 6701 penalty should not be imposed in addition to other applicable penalties, such as Section 6676 (failure to supply identification number), Section 6677 (failure to file foreign trust returns), Section 6692 (failure to file actuarial report), Section 6693(a) (failure to provide reports on IRA's), Section 6693(b) (overstatement of designated nondeductible contributions), Section 6695 (miscellaneous preparer penalties), Section 6698 (failure to file partnership returns), Section 6700 (promoting abusive tax shelters), Section 6704 (failure to keep records of certain trusts and annuity plans), Section 6705 (failure by brokers to provide notices), Section 6706 (failure to provide certain OID information), Section 6707 (failure to furnish information on tax shelters), Section 6708 (failure to maintain lists of investors in tax shelters) and Section 6709 (misstatements in mortgage credit certificates). The same conduct under any of these penalty provisions could result in liability for the Section 6701 penalty, also. In fact, it is rare to see the government proceeding under Section 6700 without also including an allegation under Section 6701.

Partial Payment Refund Remedies. Sections 6694(c), 6696 and 6703 provide refund remedies for penalties assessed under Sections 6694(a)(b), 6700, 6701 or 6702 based upon partial payment (15 percent) of the penalty and expedited (30 day) filing of a suit for refund. These partial payment refund procedures were provided in lieu of prepayment deficiency procedures at least in part because the penalties were to be assessed without regard to tax liabilities upon tax returns. Several refund cases have been dismissed because taxpayers failed to comply with the procedures, but those cases do not demonstrate that there are procedural problems. The statute should, however, be amended to remove any uncertainty regarding the time when a notice of assessment is made (mailing to last known address versus receipt) and to make clear that a defective refund suit based upon a 15 percent partial payment may be perfected by making payment in full. See Dalton v. United States, 800 F.2d 1316 (4th Cir. 1986) (upheld extension of 30-day period by letter from agent); and Thomas v. United States, 755 F.2d 728 (9th Cir. 1985) (deficiency mailing procedures of Section 6303 are inapplicable, but nevertheless held that notice of assessment was made upon mailing to preparer's last known address).

It has been suggested that prepayment deficiency procedures be available for these as well as other penalties, but there has not been any demonstration that the partial payment refund remedies have imposed a significant financial burden or denied persons a speedy and effective remedy. A review of pertinent penalty assessments and survey or other study may well be advisable to determine if relief provisions should be provided to avoid unusual hardship.

Potential Abuse by Service Personnel. In light of the exposure of professional advisors to the Section 6701 penalty, there is obviously a potential for abuse by the use of the penalty to threaten representatives during the conduct of an examination or other negotiations with the Service, especially in light of the requirement for referral to the Director of Practice if a penalty is imposed. Since the statute extends beyond returns and claims to affidavits or "other documents in connection with any manner arising under the Internal Revenue laws," the statute could obviously be used during the conduct of an examination, an appeals office conference or other proceeding.

3. Recommendations.

a) Section 6701 should be amended to provide that the penalty will be imposed with respect only to conduct which actually aids or assists, or is meant to aid or assist, in the use of a document which would result in an understatement; further, the statute should be amended to exclude as mechanical assistance any conduct which does not relate to the specific contents of a document.

b) A person should not be considered to have known that a document "will result in an understatement" of liability if the person has a good faith belief that the position taken had a realistic possibility of being sustained administratively or judicially on its merits if challenged, adequate disclosure is made in the document or return, or the person has a good faith belief that there is a basis for the document's content which is not frivolous.

c) Section 6701 should be amended to provide that the penalty is not in addition to other penalties imposed for the same individual for the same conduct.

d) The partial payment refund remedies of Sections 6694(c), 6696 and 6703 should be combined and the statute should be clarified to specify the date a notice of assessment is made and how to perfect a refund claim. A further study of the need for a relief provision to avoid unusual hardship caused by the exclusive refund remedy should be considered.

e) The Service should provide that possible consideration of the Section 6701 penalty should not be raised during an examination, appeals conference or other proceeding involving a tax advisor. The Service should issue regulations at least as to how Section 6701 applies to Sections 6694 and 6695.

E. The Frivolous Income Tax Return Penalty; Section 6702.

1. Present Law.

Section 6702 imposes a penalty of $500 when an individual files a frivolous return. A frivolous return is defined as a document which purports to be a return, but which (i) does not contain information "on which the substantial correctness of the self-assessment may be judged," Section 6702(a)(1)(A), or (ii) contains information that on its face indicates that the self-assessment is substantially incorrect Section 6702(a)(1)(B). The penalty is imposed if the taxpayer's conduct is due to (i) a position that is frivolous or (ii) a desire, which appears on the purported return, to delay or impede the administration of the Federal income tax. Sec. 6702(a)(2)(A) and (B).

The penalty may be imposed in addition to any other penalty, including the failure to file, delinquency and negligence penalties. Sec. 6702(b). The penalty is immediately assessable and the deficiency procedures under which the taxpayer would receive advance notice before assessment do not apply. However, the penalty will not be imposed in the case of innocent or inadvertent mathematic or clerical errors, including certain incorrect uses of the tax tables. _See_, _e.g._, Sec. 6213(g).

By way of example, the Senate Finance Committee's report contains the following situations, where Section 6702 may be applicable: A "purported" Form 1040 which contains altered or incorrect descriptions of line items or other altered provisions. A "purported" Form 1040 in which many or all of the line items are not filled in except for references to spurious constitutional objections. A "purported" Form 1040 in which insufficient information to calculate the tax is given or where the information given is clearly inconsistent (_e.g._, an individual claims 99 exemptions, but lists only a few dependents). A "purported" Form 1040 showing an incorrect tax due, or a reduced tax due, because of the individual's claim of a clearly unallowable deduction, such as "gold standard deduction" or a "war tax" deduction under which the taxpayer reduces his taxable income or shows a reduced tax due by that individual's estimate of the amount of his taxes going to the Defense Department budget.

Section 6703 allows for district court review of the assessment on payment of 15 percent of the amount assessed and the filing of a claim for refund of the amount paid. District Court review is not with respect to the taxpayer's actual liability, but rather is a determination of whether the penalty under Section 6702 was properly imposed. The District Court's opinion cannot have any _res judicata_ or collateral estoppel effect on the issue of the taxpayer's actual tax liability for the taxable year. The 15 percent payment is applicable to the assessment of penalties under Sections 6700, 6701, and 6702.

2. Discussion.

Prior to the passage of the TEFRA in 1982, the Service was perceived as virtually "weaponless" with respect to the filing of the "protest return." The legislative history of Section 6702 states that the Service considered itself impotent to respond in those instances where taxpayers had paid their proper tax liability through estimated payments or wage withholdings, but nevertheless filed returns purporting to be income tax returns but (i) which did not contain information on which the substantial correctness of the self-assessment could be judged, or (ii) contained information that on its face indicated that the self-assessment was substantially incorrect. P.L. 97-248, 96 Stat. 324, H.R. 4961 (Senate Finance Committee) (1982). The only available penalties were the penalty for failure to file a return, negligence, or fraud. However, these three penalties are measured as a percentage of the underpayment of the tax. Thus, if there were no underpayment (ultimately), no penalty would apply. In addition, Congress was concerned that even where there was an underpayment, it typically would take several years of administrative and judicial proceedings before any liability would be imposed.

In support for the need to draft a separate, independent, and immediately assessable penalty, Congress cited the fact that the Service held over 13,600 illegal protest returns under examination as of June 30, 1981. According to the Senate Finance Committee, "an immediately assessable penalty on the filing of protest returns will help deter the filing of such return, and will demonstrate the determination of the Congress to maintain the integrity of the income tax system." In short, Congress envisioned a penalty which was consistent with the goals enunciated by the Supreme Court in Commissioner v. Lane-Wells Co., 321 U.S. 219, 223 (1944). There the Court wrote that the system of self-assessment is the basis of our scheme of income taxation and the duty of the taxpayer to self-assess is not met unless the return is properly filled out in its entirety: "the purpose is not alone to get tax information in some form, but also to get it with such uniformity, completeness, and arrangement that the physical task of handling and verifying returns may be readily accomplished."

Section 6702 appears to serve as a significant deterrent to the use of tax protester tactics, based on the Service's overwhelming success in court. The Service has been successful in having the penalty upheld in the majority of cases challenging Section 6702 on various grounds.[20] It is ironic, however, that while part of the intent for the enactment of Section 6702 was to eliminate the administrative costs associated with the protest returns, much cost and effort is expended in defending imposition of the Section 6702 penalty itself. Indeed, it is almost as if Congress, in enacting Section 6702 and the partial payment review procedures in Section 6703, created a new (and cheap) cause of action specifically made for tax protesters to avail themselves of. However, as additional challenges to Section 6702 are summarily disposed of, the full benefit behind Section 6702 to the Service may finally be realized.

First Amendment concerns over the application of the Section 6702 penalty appear to have been adequately handled by the courts. In balancing the governmental interest in collecting tax revenues against a plaintiff's free exercise rights, the courts have found the government's interests in maintaining the integrity of the tax system generally compelling and therefore superior. The courts have determined that the interests furthered by Section 6702 are important and substantial, but also that the statute is narrowly drawn so as not to unnecessarily infringe upon the freedom of expression. Moreover, Section 6702 has not been found to deprive taxpayers of alternative means to express objections to the collection of taxes.

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[20] See Bothke v. United States, 87-2 U.S.T.C. ¶ 9470 (C.D. Calif. 1987) for a discussion of troubling facts regarding the Service's prior notification process and failure to introduce evidence in support of the penalty.

3. Recommendation.

Because of the great costs to the government in imposing Section 6702 penalties, it is recommended that the penalty be increased from $500 to $1,000.

F. Frivolous Tax Court Proceedings Penalty; Section 6673.

1. Present Law.

Prior to TEFRA, Section 6673 imposed a $500 penalty on any taxpayer who, in the judgment of the Tax Court, instituted proceedings in that forum "merely for delay." The statute authorized the court to award damages to the United States in the amount indicated. The damages sanction was imposed by the Tax Court only where it was established that the taxpayer had actual knowledge and understanding prior to trial that the posture taken was without any merit. In a "Catch-22" scenario, a taxpayer's actual knowledge of a meritless claim could only be proved by prior unsuccessful litigation in the Tax Court by the same taxpayer on the same issue, or evidence that the taxpayer was aware of other cases holding the position to be frivolous or baseless. This provision was rarely invoked seemingly due to its restrictive language, and appeared not to pose sufficient disincentives to persons filing petitions for the principal purpose of protesting against (usually on political rather than legal grounds) the income tax laws.

TEFRA amended Section 6673 to expand and increase the penalty for instituting groundless proceedings before the Tax Court. The Tax Court was authorized to award damages to the United States not to exceed $5000 whenever it determines that proceedings before it have been instituted or maintained by the taxpayer primarily for delay, or that the taxpayer's position is frivolous or groundless. It was further provided that such damages shall be assessed at the same time as the deficiency and shall be paid on notice and demand and collected as part of the tax. See Treas. Reg. Sec. 301.6673-1. Effective for proceedings commenced after October 22, 1986, damages may be awarded if the taxpayer unreasonably failed to pursue administrative remedies.

2. Discussion.

A quick review of the cases in which the Section 6673 penalty has been imposed reveals that (i) the Tax Court is growing increasingly resentful of frivolous cases, and (ii) frivolous claims are easily identifiable.

The full effectiveness of the Section 6673 penalty is still uncertain. On one hand, it is readily evident that the Tax Court has not been shy to impose the penalty (although certain cases would suggest that the penalty has been imposed in only the most egregious of circumstances. See, e.g., Wickey v. Commissioner, 43 T.C.M. 473 (1982), where the Tax Court declined to impose the Section 6673 penalty where the taxpayer (i) failed to appear at trial, (ii) refused to stipulate to relevant facts, (iii) filed a motion for indefinite continuation (which the court denied), and (iv) did not attend conferences. Although the court granted the Commissioner's motion to dismiss for failure to prosecute, it declined to impose damages under Section 6673. On the other hand, however, the incidence of Tax Court delay appears to continue undeterred. Obviously, a substantial segment of this delay is attributable to tax shelter litigation and one could reasonably expect that as many of the more prevalent shelters are "shut-down" under the Code, their presence in Tax Court will also begin to subside.

It is critical that the Section 6673 retain some "teeth." That is, the Tax Court must more aggressively dissuade tax protesters and shelter promoters, who insist on continuing litigation merely for delay. To that end, some commentators have recommended that tax petitioners be required to pay for the privilege of access before the Tax Court. This plan may operate similarly to the Section 6703 procedure which requires the taxpayer assessed with a frivolous return penalty to pay 15 percent of the penalty before access to the courts is granted. The amount would be refundable if the taxpayer's position is subsequently upheld.

3. Recommendations

No changes are recommended with respect to the frivolous Tax Court proceeding penalty, Section 6673 although further consideration of eliminating a prepayment remedy for patently frivolous petitions may be warranted.

G. Penalties for Frivolous Litigation in Courts Other Than Tax Court.

1. Present Law.

Most of the frivolous protester cases are brought in Tax Court. However, such cases are also brought in district court or the Claims Court, often in situations where the issue litigated is other than the taxpayer's actual liability for taxes, such as injunction suits or suits under Section 6703. Other than Section 7482(c)(4), involving appeals from the Tax Court, there is no specific statutory provisions imposing a penalty for frivolous litigation as to tax matters in courts other than the Tax Court. The courts, however, under common law, have the inherent power to impose attorneys fees as a sanction for frivolous litigation and have often done so in tax cases. See, e.g., Alyeska Pipeline Service v. Wilderness Society, 421 U.S. 240, 259 (1975); Callow v. Americase Corp., 681 F.2d 1242 (9th Cir. 1982).

In addition, the filing of a frivolous appeal from an adverse judgment may result in the assessment of double costs and attorneys' fees under Rule 38 of the Federal Rules of Appellate Procedure. See Paulson v. United States, 859 F.2d 61 (2nd Cir. 1985). Similarly, 28 U.S.C. Sec. 1912 authorizes the award of damages by the Supreme Court or a court of appeals where the case was brought for delay. Section 7482(c)(4) provides the same for the Tax Court and its legislative history reflects that it authorizes courts "to impose damages for frivolous appeals." H.R. Rep. No. 1, 69th Cong., 1st Sess. at 19.

Finally, Rule 11 of the Federal Rules of Civil Procedure allows the imposition of sanctions, including reasonable attorneys' fees, upon any attorney signing a pleading, motion, or other paper. The rule provides that the signature is a certificate that he has read the document and that it is warranted by existing law or a good faith argument for the extension, modification, or reversal of existing law, and that it was not filed for any improper purpose. See Aune v. United States, 582 F. Supp. 1132 (D.C. Ariz. 1984), where the court held that an attorney filing a refund suit contesting a frivolous return penalty on grounds repeatedly rejected by the courts may be subject to punishment under Rule 11. Also see, Dalton v. United States, 800 F.2d 1316 (4th Cir. 1986).

2. Discussion.

We understand that, although attorney's fees, costs and double costs are often imposed by courts as sanctions in tax cases, the government has had great difficulty in collecting those penalties outside of the Tax Court. Unlike the penalty under Section 6673, which can be assessed against the taxpayer and collected by the IRS administratively through liens and levies, sanctions imposed by district or appellate courts are simply part of the judgment, the collection of which is left up to the U.S. attorney's office or the Justice Department. Given his extensive case load, an assistant U.S. attorney will have little incentive to expend much time and effort to collect a typically small sanction (such as $2,000) against a tax protester. As a result, it is understood that the great majority of such sanctions imposed by district and appellate courts against tax protesters are simply being ignored and not collected. This undermines the purpose of such sanctions and fosters disrespect for the courts imposing the sanctions.

It would be vastly most economical and efficient to have these sanctions collected by the IRS, which has an extensive collection division and the ability to collect using methods such as liens and levies. Moreover, in many instances where a court imposes sanctions against a frivolous litigant, the IRS will already independently be attempting to collect taxes from that person. It would require no additional efforts for the IRS to collect additional court-imposed penalties, whereas it would be a great waste of time for a U.S. attorney to attempt to simultaneously collect from that same taxpayer.

3. Recommendation.

It is proposed that, where an Article III court imposes sanctions, including costs, in any tax case, and such sanctions remain unpaid more than 60 days after they become final (i.e., the time for any further review of the case has expired), the IRS should have authority to assess and collect such sanctions as if they were a tax.[21] *Cf*. Sec. 6673, providing that damages for frivolous Tax Court litigation "shall be paid upon notice and demand and shall be collected as part of the tax."

IV. THE INFORMATION REPORTING PENALTIES

A. Overview.

In recent tax legislation, Congress has both expanded the coverage of information reporting requirements and increased the level and number of penalties for failure to comply with such requirements. In general, the scope of information reporting has been expanded to improve the ability of the Internal Revenue Service to detect omitted income or overstated deductions in tax returns by collecting information from third parties with whom taxpayers engage in various transactions and at the same time to encourage taxpayers to properly report such items of income and deductions by materially reducing the likelihood of undetected noncompliance.

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[21] It might be desirable to extend such authority to assess to encompass awards to the Government of costs in tax cases even where the costs were awarded simply to the prevailing party and not as a sanction against frivolous litigation, if such costs remain unpaid after 60 days. The amounts of such awards typically are small and do not justify efforts by a U.S. attorney to collect.

Thus, traditional information reporting requirements on payers of wages, interest, and dividends and on partnerships have been augmented in recent years by information reporting requirements on brokers and barter exchanges, businesses making payments for services received (not otherwise subject to wage withholding), direct sellers of consumer goods, banks with respect to currency transactions of more than $10,000, employers with respect to tips received by their employees, recipients of mortgage interest, secured lenders of money with respect to any foreclosure or acquisition of property in satisfaction of a debt secured by that property, transferor partners with respect to a sale or exchange of a partnership interest involving unrealized receivables or appreciated inventory, and payors of royalties. In general, such third party reporting requirements are accompanied by requirements that a statement or copy of the information return be furnished to the taxpayer involved.

In addition, many recently added information reporting requirements are imposed upon individuals with knowledge of circumstances that could assist in selection of returns for audit though not related to a particular transaction between a taxpayer and a third party. Among such provisions are information reporting requirements with respect to foreign personal holding companies, foreign corporations controlled by foreign persons, U.S. persons resident abroad, amounts paid by U.S. partnerships to foreign partners, and the requirement that taxpayer identification numbers ("TINs") of dependents be included in tax returns.

Penalties associated with newly added information reporting requirements, prior to the Tax Reform Act of 1986 generally were standard in amount, typically $50 per failure to comply (either to file information return or to furnish a statement to the taxpayer) with an aggregate maximum of $50,000 in any calendar year for any one type of failure. Generally, the penalty would not apply where the failure was due to reasonable cause and not to willful neglect. Sometimes a higher per failure penalty was imposed where the failure was due to willful neglect, with no maximum per calendar year.

1986 Act Changes. First, the 1986 Act raised the general maximum penalties for failure to file an information return or for failure to supply a copy to the taxpayer from $50,000 to $100,000 for each category of failure. The 1986 Act also consolidated the general penalty for failure to file an information return and the general penalty for failure to furnish a copy to the taxpayer in the same subchapter of the Internal Revenue Code of 1986. The 1986 Act also redrafted these penalties to improve their comprehensibility and administrability. Also, the 1986 Act clarified that the requirement to furnish a written statement to the taxpayer under a number of the substantive information reporting provisions is triggered where there is an obligation to file the information return (instead of by the actual filing of the return, as arguably obtained under prior law).

Taking into account amendments by the 1986 Act, the general level of the penalties for failure to file an information return with the Service and for failure to supply a copy to the taxpayer is $50 for each failure (as under prior law), subject to a maximum of $100,000 for each category of failure. Thus, a maximum penalty of $100,000 applies to failure to file information returns with the Service, and another maximum penalty of $100,000 applies to failure to supply copies of information returns to taxpayers. The penalties are imposed without limits where the failure to file information returns is due to intentional disregard of the filing requirement. Also, as under pre-1986 Act law, generally higher penalties are provided for each failure where the failure is due to intentional disregard. The 1986 Act modifies the levels of higher penalties for certain specified failures.[22]

Second, the 1986 Act added to the Code a new penalty for failure to include correct information either on an information return filed with the Service or on the copy of that information return supplied to the taxpayer (Section 6723). This new penalty applies to either an omission of information or an inclusion of incorrect information. The amount of the penalty is $5 for each information return or copy for the taxpayer, up to a maximum of $20,000 in any calendar year. This maximum does not apply in cases of intentional disregard of the requirement to file accurate information returns.

The new penalty is intended to provide to persons filing information returns an incentive both to file accurate and complete information returns initially and to correct as rapidly as possible any incorrect information returns that may have been filed. However, if a person files a document purporting to be an information return that contains so many inaccuracies or omissions that its utility is minimized or eliminated, the Service may (as under pre-1986 Act law) impose the penalty for failure to file an information return (a higher penalty), rather than this new penalty for filing an information return that includes inaccurate or incomplete information. (Both penalties may not be imposed with respect to the same information).

Further, the new penalty does not apply to an information return if a penalty for failure to supply a correct taxpayer identification number has been imposed with respect that information return. Thus, if the person filing an information return is subject to a penalty under Section 6676 for including an incorrect social security number on the information return, the new penalty is not imposed with respect to that information return.

The 1986 Act also raises from $50,000 to $100,000 the maximum penalty for failure to supply taxpayer identification numbers, provided in Section 6676.

If the failure to file an information return or to supply a copy to the taxpayer or to include correct information on either of those returns is due to reasonable cause and not to willful neglect, no penalty will be imposed.

In cases of interest and dividend returns or statements, the $20,000 and $100,000 limits are inapplicable. The penalties can be avoided, however, by a showing of due diligence, rather than reasonable cause.

In enacting the 1986 Act changes, Congress believed that simplifying these penalties, consolidating them, and making them more comprehensible would have a beneficial impact on tax compliance. Congress intended to enable taxpayers to understand more easily the consequences of noncompliance, and also to facilitate the Service's administration of the penalties.

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[22] Thus, the penalty for failure to report cash transactions that exceed $10,000 (Section 6050I) is increased to 10 percent of the amount that should have been reported. Also, the penalty for failure to report exchanges of certain partnership interests (Section 6050K) or failure to report certain dispositions of property (Section 6050L) is 5 percent of the amount that should have been reported.

Congress also believed that persons required to file these information returns (and provide copies to payees) who include incorrect information on them should be subject to a penalty.

Further, Congress was concerned that then existing maximum of $50,000 per calendar year for each of these penalties might diminish the efficacy of these penalties in instances where there had been a massive failure to file these information returns. Congress was also concerned, however, that total elimination of these maximum amounts could subject taxpayers to enormous potential liability that would be disproportionate both as to the taxpayer's culpability and as to the penalties for many other Federal offenses. Consequently, Congress preserved a maximum amount for each of these penalties, but also raised the dollar amounts of those penalties.

1987 Act Changes. The Revenue Act of 1987 made certain relatively minor changes in the information reporting requirements and associated penalties applicable to pension plans and tax-exempt organizations.

Proposed Legislation. Section 115 of the Technical Corrections Bill of 1988 (H.R. 4333/S.2238) would subject to the general penalty for failure to furnish payee statements as required (Section 6722) a failure to comply with the existing law requirement that any person holding an interest in a partnership as a nominee for another person must furnish to the partnership the name and address of that other person (along with any additional information required by regulations (Section 6031(c)). The general penalty under existing law is $50 per failure, up to a maximum of $100,000 per calendar year.

Also, the Technical Corrections Bill makes certain relatively minor changes in the information reporting requirements, relating to broker reporting requirements, certain Federal contracts, and payors of royalties.

B. Standardization of Penalty Amounts.

1. Present Law.

Under present law, penalties for a failure to satisfy a number of the information reporting provisions already are standardized. Thus, Section 6721 provides the penalty for failure to file an "information return" with the Secretary, Section 6722 provides the penalty for failure to furnish a "payee statement" (or for failure to furnish a notice to a partnership of exchange of partnership interest), and Section 6723 provides the penalty for including incorrect or incomplete information in an "information return" or "payee statement."

For these provisions, an "information return" is defined as any statement of the amount of payments to another person required by a list of Code Sections including those relating to (1) certain information at source (Section 6041(a) or (b)); (2) payments of dividends (Section 6042(a)(1)); (3) payments of patronage dividends (Section 6044(a)(1)); (4) payments of interest (Section 6049(a)); (5) payments of royalties (Section 6050N(a)); (6) information returns with respect to income tax withheld (Section 6051(d)) and certain others.

Also within the meaning of the term "information return" are certain returns required by another list of Code Sections, including those sections that require (1) returns of direct sellers (Section 6041A(a) or (b)); (2) returns of brokers (Section 6045(a) or (d)); (3) returns relating to mortgage interest received in trade or business from individuals (Section

6050H(a)); (4) returns relating to cash received in trade or business (Section 6050I(a)); (5) returns relating to foreclosures and abandonments of security (Section 6050J(a)); (6) returns relating to exchanges of certain partnership interests (Section 6050K(a)); (7) returns relating to certain dispositions of donated property (Section 6050L(a)); (8) reporting with respect to certain tips (Section 6053(c)(1)); and certain others.

The term "payee statement" means any statement required to be furnished under a list of Code Sections, including those corresponding to many of the above information return provisions.

Standard amounts, waiver provisions, payment and contest provisions apply to all of the specified failures to satisfy requirements to file these "information returns" and to furnish these "payee statements," correctly and completely. Thus, in the case of each failure to file an information return with the Secretary on the date prescribed therefor (determined with regard to extensions), the person failing to file such return is liable to pay $50 for each such failure, but the total amount imposed on such person for all such failures during any calendar year shall not exceed $100,000.

However, if one or more of the failures to which this general rule applies are due to intentional disregard of the filing requirement, then, with respect to each such failure, the penalty imposed is $100 or, if greater, a penalty calculated as a particular percentage of the aggregate amount of the items required to be reported (10 percent in the case of a return other than a return required under Section 6045(a) (relating to brokers), Section 6041A(b) (relating to direct sales), Section 6050H (relating to mortgage interest received), Section 6050J (relating to foreclosures and abandonments of security), Section 6050K (relating to exchanges of certain partnership interests), or Section 6050L (relating to certain dispositions of donated property) and 5 percent in the case of a return required under Section 6045(a) (relating to brokers), Section 6050K (relating to exchanges of certain partnership interests), or Section 6050L (relating to certain dispositions of donated property)). In the case of any penalty for a failure due to such intentional disregard, the $100,000 limitation does not apply and such penalty is not taken into account in applying the $100,000 limitation to penalties for failures not due to intentional disregard.

As more fully enumerated below, other information reporting provisions have separate, and varying, penalty amounts, most of which are flat dollar amounts (not a percentage of the amount of a specified item) and many of which do not have maximum limitations.

2. Discussion.

It is thought by many that an understandable penalty system will have a greater deterrent effect than one which is not understandable (and thus may be regarded as capricious). In the information reporting area, standardization would contribute to understandability and for that reason appears desirable. Considerations similar to these prompted Congress to make the 1986 Act changes in the information reporting penalties.

For the most part Congress has adopted a flat dollar amount penalty, rather than a percentage. The generally applicable amount is $50. In cases where a percentage is adopted, the percentage relates to the amounts of those items required to be reported. Thus, such percentage penalties may relate in some way to the scale of revenue for which the required information return would serve as a "lead" to the Service. These may or may not relate to the "tax harm" involved.

Congress has adopted a higher flat dollar amount, generally $100, where intentional disregard of reporting requirements is involved, and no "cap" applies. Presumably, the reporter's culpability is higher in such instances and so a higher penalty may be appropriate.

Consideration should be given to the merit of variable penalties in the information reporting area. To some, it appears unfair to impose the same penalty for the failure to report a small item as applies to the failure to report a large item. This perception may be based upon the assumption that more tax would be involved where the amount to be reported is large than where it is small. If that were true, the report of a large amount might be more important to the Service than one of a small amount (e.g., as a "lead" to back tax revenues). Also, if the reporter were assumed to be aware of this situation, the reporter's culpability would be greater where he fails to report a large amount than a small amount.

The size of the item may indeed bear on the importance of a particular information return to compliance efforts. If that is true, it may be appropriate to provide the reporter, who has no tax of his own at stake[23], a higher incentive to report. Without such incentive, some reporters may be tempted to collude with taxpayers in failing to report. Also, a tougher penalty may reinforce the taxpayer's belief that information returns are being filed and that, therefore, the chances of his failure to report the item escaping detection are low.

In general, the information reporting penalties should increase from a minimum to a maximum amount depending on the period of delinquency in the same manner as the delinquency penalties imposed on taxpayers by Section 6651. The existing information reporting provisions could be described as "cliff" type penalties. That is, the full amount of the penalty applies immediately on the first day an information report becomes delinquent. In this circumstance, there is no incentive for a delinquent reporter to file a late return. Late information or corrected information may be useful to the Service for some period after the due date for the filing of the report.

In fashioning the proper variation in penalty amount depending upon the period of delinquency, the following features of Section 6651 should be considered. The failure to file and failure to pay penalties are geared to the due date determined with regard to any extensions of time for filing or payment, respectively. Consideration should be given to the availability of extensions of time to file information returns in certain circumstances (such as first-time filers of small filers, who are trying but are unable to comply on time).

The Section 6651 penalties increase in equal steps up to a maximum. The amount of the penalty generally is dependent upon the amount of tax involved. Thus, the failure to file penalty (Section 6651(a)(1)) provides for an addition to the amount required to be shown as tax on the return of 5 percent of the amount of such tax if the failure is for not more than 1 month, with an additional 5 percent for each additional month or fraction thereof during which such failure continues, not exceeding 25 percent in the aggregate. There is a minimum penalty of $100 for returns filed 60 days or more late. The failure to pay penalties (Section 6651(a)(2) and (3)) are similar but at lower rates. The failure to pay penalty is imposed at a higher rate when the IRS has given notice of intent to levy.

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[23] In some instances, the third-party reporter may have potential non-tax liability at stake. See, Clemens v. USV Pharmaceutical, A. Div. of Revlon, 838 F.2d 1389 (5th Cir. 1988) (employer held liable under Louisiana tort law for injury to former employee resulting from employer's filing of erroneous Form W-2 and later failing to correct it promptly which contributed to IRS tax audit of former employee).

In the case of information returns, generally, it appears that the time period during which the maximum penalty is "phased in" should correlate with the period during which the information will be useful to the Service.[24] Presumably, the penalty should be "phased in" by rather even steps. Otherwise, the penalty would, in effect, simply establish another later deadline. Later deadlines may be feasible because of the particular use to the Service of the information. However, it would be unfair to the person who complied with the original due date not to penalize those who do not file for some time thereafter.[25]

Variation in rates depending upon the relationship between the particular period of delinquency and the dates of IRS need for information should be considered. Also, the rate of penalty clearly could be higher after the IRS has notified the reporter of his delinquency in meeting the information reporting obligation.

The particular way in which these concepts would bear on particular penalty provisions depends in part upon IRS information concerning its need for and capacity to process particular information. Accordingly, only the general recommendation to vary the penalty amount depending upon the period of delinquency and the general suggestion to consider the feasibility of varying the penalty rate according to the size of the amount to be reported are made at this time with respect to the penalties provided in Sections 6721, 6722 and 6723, i.e., those generally applicable concerning the specified "information returns" and "payee statements." As to basic levels where the penalties are flat dollar amounts, Congress apparently sought to accommodate relevant policy concerns in increasing the flat dollar amounts and applicable maximums as part of its consolidation of the generally applicable penalties for failure to file "information returns" and "payee statements" in Sections 6721 and 6722 (as amended by the 1986 Act), and it appears premature to propose a change in the levels absent relevant data (such as empirical data as to

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[24] It should be noted that, by temporary regulations under Section 6723 (correct information requirement), the Service has provided that a penalty will not be assessed for omissions and inaccuracies that are corrected timely. Reg. Sec. 301.6723-1T(c)(1). Under the regulations, timely correction does not prevent assessment of the penalty for any failure that is part of a pattern of conduct of repeatedly failing to include correct information, or for any failure that is intentional. Reg. Sec. 301.6723-1T(c)(2). See discussion, infra.

[25] Another concept which might be investigated is the possibility of rewarding compliant individuals. This concept requires considerable study in light of social science research concerning the dynamics of compliance and may be relevant outside the information reporting area. Funding for such a reward system presumably would be one of the more difficult issues in adopting a reward system, even if theorists agreed that rewards would promote voluntary compliance.

Finally, Congress should consider removing the "notch" problem in connection with magnetic media reporting. Currently, the statute requires magnetic media in the case of interest and dividends reports where more than 50 payers are involved for any calendar year. A similar "notch" problem exists for other information reports under applicable regulations. See Reg. Sec. 301.6011-2(c)(1). Consideration should also be given administratively to the waiver of penalties for minor miscalculations, especially in cases of "first-time" offenders. Otherwise, there exists an incentive not to report payments to certain payees in order to avoid penalties.

3. Recommendations.

a) The rate of information reporting penalties should be standardized with an aggregate limit per calendar year, and higher penalties where the failure to satisfy reporting requirements is due to intentional disregard. However, the penalties provided in Section 6721-6724 (and probably many other information reporting penalties) should permit (or perhaps require) substantial abatement (*i.e.*, reduction in amounts by 80 percent - 90 percent) when "first-time" offenders promptly provide data after notice from the Service, particularly when late information is likely to be useful to the Service. Penalty rates (or abatement policy) should be structured in such a manner that it is always in the taxpayer's interest to correct erroneous information.

b) Consideration should be given to variation in penalty rates depending upon the relative size of the item to be reported in the information report (sometimes referred to as a "tax harm" standard).

C. Waiver Discretion and Standards

1. Present Law

Section 6724 of the Code provides that no penalty will be imposed for certain failures to comply with information reporting requirements. The statute articulates two criteria by which such failures may be excused. Generally, no penalty will be imposed for failures to comply with reporting requirements which are due to "reasonable cause" and not to willful neglect. Where information reports concerning interest or dividend payments are required, however, a penalty will be imposed for any failure to comply unless the person required to make the report has exercised "due diligence" in attempting to comply with the reporting requirement.

"Reasonable cause" and "due diligence" are not defined in Section 6724, its legislative history, or accompanying regulations. These standards, however, have fairly uniform definitions throughout the Code and Treasury Regulations. "Reasonable cause" consists of the exercise of ordinary business care and prudence. See e.g., Walter v. Commissioner, 753 F.2d 35 (6th Cir. 1985); In re Brown, 743 F.2d 664 (9th Cir. 1984) (construing standard under Section 6651). "Due diligence" consists of the care that a reasonably prudent payor would use in the course of the payor's business in handling account information such as account numbers and balances. Temp. Treas. Reg. Sec. 35a. 9999-1 (1983); 1983 U.S. CODE CONG. & AD. NEWS, 688 (legislative history relating to taxpayer identification number reporting requirements under Section 6676(b)).

The "due diligence" standard was intended to impose a higher burden on information reporters and thereby increase the disincentive for noncompliance. Relevant legislative history indicates that House and Senate Conferees replaced the "reasonable cause" standard because it had been applied so liberally that the purpose of the taxpayer identification reporting requirements and penalties had been frustrated. 1983 U.S. CODE CONG. & AD. NEWS, 687.

Several aspects of the fairness of the waiver standards have been addressed administratively. Thus, the temporary regulations under Section 6723 (correct information requirement) provide an exception for inconsequential omissions and inaccuracies, which is tied to the purpose for the particular information reporting requirement involved. Thus, under this exception, the penalty will not be assessed for any failure to include correct information on an information return if the failure did not prevent the Service from processing the return or from correlating the information required to be shown on the return with the information shown on the payee's return. Reg. Sec. 301.6723-1T(b)(1). Similarly, the penalty will not be assessed with respect to a payee statement if the failure cannot reasonably be expected to prevent or hinder the payee from receiving correct information and reporting it on his or her tax return. Id.

Also, to encourage the reporting of correct information, the temporary regulations under Section 6723 provide an exception for corrected failures. Under this exception, the penalty will not be assessed for omissions and inaccuracies that are corrected timely. Reg. Sec. 301.6723-1T(c)(1). To be considered timely, a correction must occur by the earliest of: (1) 30 days after the person who filed the return or furnished the statement discovers the failure; (2) 30 days after the date of a written request from the Service for corrected information; or (3) October 1 (March 1 for payee statements) of the calendar year in which the return or statement is due. Under the regulations, timely correction does not prevent assessment of the penalty for any failure that is part of a pattern of conduct of repeatedly failing to include correct information, or for any failure that is intentional. Reg. Sec. 301.6723-1T(c)(2).

The October 1 deadline for correcting information returns reflects the Service's need to receive corrected returns in time to process them with other information returns. The March 1 deadline for correcting payee statements reflects the need of payees to include correct information in their tax returns due April 15.

The temporary regulations prescribe a specific procedure for establishing reasonable cause (or due diligence). Under the temporary regulations, a written statement must be submitted that sets forth all the facts alleged as reasonable cause (or due diligence) and make an affirmative showing of reasonable cause (or due diligence). The statement must be signed by the person required to file the information return or furnish the payee statement to which to which the penalty relates, and must contain a declaration that it is made under the penalties of perjury.

Also, the temporary regulations provide guidance as to "undue hardship." In general, a payor of a post-1983 account or instrument is not liable for a penalty under Section 6676(b) for filing an information return with a missing or an incorrect taxpayer identification number if the Service determines that the payor could have satisfied the due diligence requirements but for the fact that the payor incurred an undue hardship. According to the regulations, an undue hardship is an extraordinary or unexpected event such as the destruction of records or place of business of the payor by fire or other casualty (or the place of business of the payor's agent who under pre-existing written contract had agreed to fulfill the payor's due diligence obligations under Section 6676(b) with respect to the account subject to the penalty and there was no means for the obligations to be performed by another agent or the payor.) Undue hardship will also be found to exist if the payor could have met the due diligence requirements only by incurring an extraordinary cost. Temp. Treas. Reg. Sec. 35a.9999-3 (A-67) (as amended by T.D. 8163 (November 17, 1987)).

2. Discussion.

Although the "due diligence" standard ostensibly imposes a higher burden upon information reporters, there seems to be little (if any) substantive difference between its requirements and those imposed under the "reasonable cause" standard. Moreover, reporter noncompliance with Section 6676(b) apparently was not due to any inherent inadequacy in the "reasonable cause" standard but, rather, was the result of overly liberal application of the standard. It follows that the introduction of the "due diligence" standard may not ultimately result in a solution to the problem of reporter noncompliance.

An effective compliance mechanism does, however, require clearly articulated standards. Moreover, a single standard would be preferable to a dual standard. And since "reasonable cause" and "due diligence" would appear to be essentially the same standard, a modest step in constructing an effective compliance mechanism for information reporting should be the consolidation of these standards. First, this procedure would streamline the information reporting statutes and regulations. Second, it would facilitate both reporter compliance and the Service's enforcement.

A uniform reporting standard based upon "reasonable cause" criteria seems desirable.[26] "Reasonable cause" has the advantages of being an objective standard and being flexible enough to permit case-specific determinations concerning compliance.

The particular "due diligence" requirements applicable, for example, to the failure to include a correct taxpayer identification number, should be treated as defining "safe harbors" under the standard. As such, they offer a range of certainty that is desirable in an area which affects a large number of persons subject to the reporting requirement. Moreover, existing temporary and proposed regulations reflect the exercise of administrative discretion in defining such safe harbors. (It is noted that for the present it is generally beyond the scope of this report to assess the wisdom of the particular requirements set forth by temporary, proposed or final regulations in defining safe harbors as to "reasonable cause" or "due diligence.")

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[26] See Statement of Johnny Finch, Deputy Director, General Government Division, U.S. General Accounting Office, Hearing on Review of the Civil Penalty Provisions Contained in the Internal Revenue Code Before the Subcomm. on Oversight of the House Comm. on Ways and Means, 100th Cong. 2d Sess. 12 (March 31, 1988) (referring to IRS abatement procedures, which are applicable to both computer-generated and manually generated penalties, stating that 26 percent of "reasonable cause" abatements (12,700) out of 48,800) in 1984 were inappropriate, and attributing the inappropriate abatements to (1) incomplete IRS guidance defining reasonable cause, (2) minimal penalty training, and (3) inadequacies in IRS review and quality assurance processes, and stating that the IRS had taken action on the 1984 GAO recommendations and that current IRS practice regarding abatements is not yet known to GAO).

3. Recommendations.

a) A unitary standard for waiver, either "reasonable cause" or "due diligence," should be adopted instead of the present dual standards of "reasonable cause" and "due diligence." The Service should continue to provide a notification procedure for claiming waiver for "reasonable cause" or for "undue hardship" to preserve the integrity of the reporting system and also continue to provide detailed "safe harbors" (but not exclusive formulae) for a determination that "reasonable cause" or "due diligence" exists. "Due diligence" could amount to a safe harbor category under the "reasonable cause" standard, if that were adopted as the uniform standard, in the case of payments of interest and dividends.

b) A standard administrative procedure, such as that set forth in the existing temporary regulations under Section 6723, should be prescribed for obtaining waiver of the penalties for reasonable cause, due diligence or undue hardship.[27]

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[27] It may be appropriate to provide (by statute) that the taxpayer may (but is not required to) obtain an advance ruling that reasonable cause exists for not complying with an information reporting provision (or for complying in part or in a modified manner) prior to the due date of the information return involved. Where a large volume of returns and a potentially high penalty are at stake and little guidance exists as to what will be held by the Service to constitute reasonable cause not to comply (wholly or in part) with an information reporting requirement, compliant reporters might welcome the opportunity to test their view of reasonable cause prior to rather than after the fact.

Mr. **Saltzman**. Now we are going to have remarks on the taxpayer penalties themselves from Mr. Muller.

Thank you.

Chairman **Pickle**. All right. I presume that will be presented by Mr. Muller?

Mr. **Muller**. Yes, sir.

Chairman **Pickle**. All right, Mr. Muller, if you will proceed.

STATEMENT OF CHARLES J. MULLER, MEMBER, SECTION OF TAXATION, AMERICAN BAR ASSOCIATION

Mr. **Muller**. Mr. Chairman, may I use some examples here and go to these boards?

Chairman **Pickle**. Yes.

Mr. **Muller**. Mr. Chairman, I have prepared here some examples that demonstrate the problem that you have heard said many times that the penalties overlap and pyramid. I wanted to show you how that presently exists in the system and tell you a little bit about how it happened that these penalties came to pyramid.

The taxpayer penalties consist basically of five penalties——

Chairman **Pickle**. Let me ask, can the audience hear? Can you hear him over there where he is? If you will just speak louder it will be all right, or take the microphone. Just speak louder, that is the main thing. And next time you might bring a chart up that is a little bit larger. [Laughter.]

Mr. **Muller**. These examples are also printed and in the material that has been handed out, too. We have five taxpayer penalties. Three of them are general penalties that have been in the system since 1918. Those penalties are fraud, negligence, and delinquency. They are broad-based penalties. They apply to a general category of conduct, fraud, or failure to conform, negligence, or delinquency.

Then in 1981 and 1982 we began adding new penalties. We added two specific penalties that apply to specific conduct. That is, overvaluation and substantial understatement, and we began to add interest components to the code. This example will show—these five examples will show what we now see as pyramiding penalties. I have chosen amounts that are just for illustrative purposes only. They have no particular significance.

[The examples referred to follow:]

EXAMPLE 1

Taxpayer files his 1987 income tax return timely, reflecting a total tax liability of $30,000. The $30,000 was timely paid by quarterly estimated tax payments. On audit, IRS assesses additional taxes of $1,000 because it is determined that the taxpayer has carelessly failed to maintain certain records to support expense deductions.

PRESENT LAW

Penalty Computation:
Negligence: 5% x $1,000 = $50 + interest*

PROPOSED CHANGE

Penalty Computation:
Negligence: 25% x $1,000 = $250

*"Interest" as used in these examples refers to the interest component of the penalty.

EXAMPLE 2

Same facts as Example 1, except that IRS asserts additional tax for another item which is determined to be "no fault." The tax liability for this item is $30,000.

PRESENT LAW

Penalty Computation:
Negligence: 5% x $31,000 = $1,550 + interest
Substantial Understatement: 25% x $31,000 = 7,750
$9,300 + interest

PROPOSED CHANGE

Penalty Computation:
Negligence: 25% x $ 1,000 = $250

EXAMPLE 3

Save facts as Example 2, except that taxpayer asserts and proves that the $1,000 adjustment for undocumented business expenses, was in fact attributable to fraud:

PRESENT LAW

Penalty Computation:
Fraud: 75% x $ 1,000 = $ 750 + interest
Substantial Understatement: 25% x $31,000 = 7,750
$8,500 + interest

PROPOSED CHANGE

Penalty Computation:
Fraud: 75% x $1,000 = $ 750

EXAMPLE 4

PRESENT LAW

Penalty Computation:
Delinquency: 5% x $31,000 = $ 1,550
Negligence: 5% x $61,000 = 3,050 + interest
Substantial Understatement: 25% x $61,000 = 15,250
$19,850 + interest

Same facts as Example 2, except taxpayer files his tax return one month late.

PROPOSED CHANGE

Penalty Computation:
Delinquency: 5% x $31,000 = $1,550
Negligence: 25% x $1,000 = 250
$1,800

EXAMPLE 5

Same facts as Example 2, except taxpayer files his tax return one year late after several contacts by IRS.

PRESENT LAW

Penalty Computation:

Delinquency:	25% x $31,000 =	$ 7,750	
Negligence:	5% x $61,000 =	3,050	+ interest
Substantial Understatement:	25% x $61,000 =	15,250	
		$26,050	

PROPOSED CHANGE

Penalty Computation:

Delinquency:	25% x $31,000 =	$ 7,750
Negligence:	25% x $ 1,000 =	250
		$ 8,000

Mr. MULLER. In this first example we have a taxpayer who files his 1987 tax return timely and he has a tax liability of $30,000 which he also has paid timely by estimated tax payments. And because of a failure on his part to maintain the proper records to substantiate the deductions, he is assessed on audit a $1,000 adjustment to his tax return with a negligence penalty. That is computed—at present the negligence penalty is 5 percent times $1,000, so he pays $50 penalty plus he has this little interest component, this hidden penalty enhancer that is in the penalty.

Under the recommendations we would make, if for example this committee took a 25-percent carelessness charge, the penalty you would pay would actually go up but it would not have the interest component in it. You would pay 25 percent of $1,000—$250—but you would not pay the interest component. You would also be subject to regular interest on the deficiency.

In example No. 2 we have changed the facts just a little bit. That is, that we have added a no-fault adjustment of $30,000.

Chairman PICKLE. Before you go to No. 2, let me ask you, this is in the case of where the taxpayer just carelessly made a $1,000 error out of $30,000.

Mr. MULLER. That is right.

Chairman PICKLE. That is not a very big error, or is it a very big error, in your opinion?

Mr. MULLER. That would be, I think, a fair example of what happens, for example, failure to keep proper records of your mileage on your car. That is the kind of adjustment that——

Chairman PICKLE. There is no reference to intentional or personal fraud in this case, just carelessness?

Mr. MULLER. That is right.

Chairman PICKLE. Whereas now you have a $50 penalty, now you would sock him for $250?

Mr. MULLER. That is right.

Chairman PICKLE. Just for being careless?

Mr. MULLER. I can explain why that——

Chairman PICKLE. One out of 30.

Mr. MULLER. What happened in our penalty structure, sir, we had a 5-percent negligence penalty all the way through to the latter part of the 1970's. But in the 1970's we had a prime interest rate that went up to 21 percent; we had inflation of 13 percent. And when you had a 5-percent negligence penalty with a 6-percent interest rate, your 11-percent charge per annum, it was to a taxpayer's advantage to have a deficiency.

So we felt that the 5-percent penalty is probably too low in today's era. So that is the reason we recommended that.

In example No. 2, we have a $30,000 no-fault adjustment. This is—Mr. Saltzman talked about an inventory adjustment. We are not going to—this is a fact situation that does not involve any question of intentional conduct, or this could be an accidental no-fault adjustment. Here this shows, sir, how the 5-percent negligence penalty pyramids with the substantial understatement penalty.

Now the 5 percent does not apply just to the $1,000 adjustment, but it also applies to the no-fault adjustment of $31,000 so that the negligence penalty is now 5 percent times $31,000 giving you a $1,550 adjustment. Plus you have this no-fault penalty on substantial understatement, which is 25 percent of the same base. So you actually end up with a 30-percent penalty plus the interest component on negligence and you have a $9,300 penalty.

As we propose the change, you would just have a simple 25-percent negligence penalty that would apply to the $1,000, and there would be no penalty that would apply to a no-fault adjustment. Interest would be due to compensate the Government for the late payment of money.

Under example 3—we have done this one, Mr. Chairman, to show the anomaly. We now have a fraud penalty that is specific. That is that 75 percent of the specific portion of the understatement that is attributable to fraud. But we have a negligence penalty that applies 5 percent to the whole tax adjustment.

So we wanted to show here that in some circumstances it would be to a taxpayer's advantage to argue under the present code that his adjustment for negligence was actually fraudulent. That he did not carelessly fail to maintain records, that he intentionally failed to maintain records, and/or failed to have a proper deduction.

Here instead of having a 5 percent of $31,000, you end up with 75 percent of $1,000. He actually has paid less money in a fraudulent situation than he would have in example No. 2. That just illustrates the glitch between having a specific items fraud penalty and a broad-based negligence penalty.

In example No. 4, we have a series where the delinquency penalty pyramids. Here we have the same set of examples as in example No. 2, same fact pattern, but we have a 1-month delinquency in the filing of the return.

Here the delinquency penalty applies to the entire understatement, 5 percent of $31,000. This is the delinquency, failure to file. But we also have the negligence penalty going back and pyramiding. By that, the taxpayer has the negligence penalty asserted not only on what he failed to timely pay, but also on what he paid timely.

In other words, he paid $30,000 of this $61,000 timely and he is only guilty of being a month late with his tax return and he is now going to have to pay 5 percent of the $30,000 he paid timely in addition to the amount he paid late. You see, the combination gives you actually, in effect, a 10 percent penalty on the deficiency portion and a 5 percent on the timely paid portion of the total tax adjustment.

Chairman PICKLE. Are you saying, Mr. Muller, in example 4, that under the present law if the taxpayer files his return 1 month late he could be fined based on delinquency, negligence, and substantial understatement, he could be fined $19,850?

Mr. MULLER. Plus the interest component.

Chairman PICKLE. Plus interest.

Mr. MULLER. Plus interest on the tax and deficiency. So if you would assume a 2- or 3-year delay, for example, in the audit cycle, this taxpayer might pay more than his entire tax deficiency in penalties and interest. It would be very common for that to happen.

Chairman PICKLE. That would exceed his $30,000 or $31,000 original payment.

Mr. MULLER. That is right. In other words, the penalty here, that would assume that the penalty was paid with no interest component in the penalty and with no interest on the regular interest provision. So you can——

Chairman **Pickle**. But you would not do that just because of one month delay.

Mr. **Muller**. Yes, sir.

Chairman **Pickle**. But because he also had an element of negligence and/or understatement.

Mr. **Muller**. That is right. Here we have, this taxpayer his fault, his two faults: one, he has failed to maintain records for $1,000 worth of deductions. And two, he has been 1 month late in his tax return. Those are the only faults this taxpayer is guilty of and he has received this $19,000 penalty.

Chairman **Pickle**. And in some instances, if that went on, you would be paying more than his original amount.

Mr. **Muller**. Yes, sir.

Chairman **Pickle**. Does that happen often?

Mr. **Muller**. I think it is going to be very common, sir. And it is hard to get that taxpayer back into the system when he has got these terrible penalties on audit to pay.

Mr. **Flippo**. Would the chairman yield for a question at this point?

Chairman **Pickle**. Yes.

Mr. **Flippo**. Do you have any kind of—you say that you think it occurs with some frequency. Do you have any statistics or any kind of data that you might give us?

Mr. **Muller**. I do not have any statistics.

Mr. **Flippo**. Was there any involved in your studies?

Mr. **Muller**. No, we just used the Commissioner's report which is a lump figure.

Under the proposed change, Mr. Chairman and members, this taxpayer has been 1 month late and failed to maintain records for $1,000 would just pay an $1,800 penalty plus the interest he owes to the Government for not paying timely.

Under example 5 the total penalty gets all the way up to $26,000, and that happens because this taxpayer was a year late and he was requested several times by the Service to file his tax return. So his fault here is the failure to maintain records for a $1,000 deduction, he was a year late on his tax return, and he did not promptly respond to the Service's several requests that he file his return.

In that situation his penalty is $26,000. This again showing how these penalties will pyramid in a situation involving not great fault.

Mr. **Flippo**. None of your examples includes statutory interest.

Mr. **Muller**. No, it does not. It does not include the regular interest rate that——

Mr. **Flippo**. So, Mr. Chairman, in addition to the figures that he is presenting, there would in addition to that be interest for the period of time until collection. What is that today, about 10 percent?

Mr. **Muller**. Yes. So you can see if you have a 3- or 4-year delay this taxpayer is going to pay well over his deficiency in penalties and interest. He might pay 200 percent of his deficiency just as penalties and interest and the taxes due.

Mr. **Shaw**. Mr. Chairman, could I add a question to Mr. Flippo's?

Chairman **Pickle**. Mr. Shaw.

Mr. **Shaw**. How much of these penalties are discretionary with the Service or specifically with the agent in charge of the audit?

Mr. **Muller**. My experience is that the agents will not exercise discretion on an audit. If you want to go to a discretionary level you have to—you need to hire a representative usually in order to appeal, although that is not strictly required. But is only at the appeals level that you get into discretionary procedures in my experience.

These penalties can all be abated on reasonable cause shown. And if you go up to appeals and this situation—I would say, my experience is that if you get up to that level and you do have some reasonable explanation and the penalties are distorted, you can get relief there. But there are a great number of taxpayers who do not go up to that level to receive the benefit of that discretion.

Thank you, sir.

[The statement of Mr. Muller follows:]

CHARLES J. MULLER, CHAIR
PENALTIES TASK FORCE
SECTION OF TAXATION
AMERICAN BAR ASSOCIATION

Mr. Chairman and Members of the Committee:

INTRODUCTION

I am Charles J. Muller, San Antonio, Texas, Chair of the Penalties Task Force. I will outline the Task Force recommendations concerning the taxpayer penalties.

THE TAXPAYER PENALTIES

There are five separate penalties which make up those that the Task Force refers to as the "taxpayer penalties." These penalties are assessed against the taxpayer for understatement of his tax liability and for delinquency in filing his return or paying his taxes. Three of these provisions apply to general categories of misconduct and have existed in the Internal Revenue Code since the early days of the tax law. They are the fraud penalty, the negligence penalty and the delinquency penalty.

The fraud penalty applies where a taxpayer "attempts to evade" tax. The negligence penalty applies where a taxpayer intentionally disregards rules and regulations or carelessly fails to report his correct taxes. The delinquency penalty applies where a taxpayer fails to timely file a return or pay his taxes.

Two more specific penalty provisions were added in recent years. In 1981 and in 1982, respectively, Congress added the overvaluation penalty, Section 6659, and the substantial understatement penalty, Section 6661. The overvaluation penalty applies where a taxpayer understates his tax liabilities by relying on overstated valuations of property, commonly occurring in tax shelters. The substantial understatement penalty is a "modified no fault" penalty, which applies where a tax understatement exceeds certain mathematical limits. The overvaluation penalty and the substantial understatement penalties are not coordinated with the three general penalties and consequently significant overlapping and pyramiding of the penalties can result. For example, conduct which could be described under the general heading "intentional disregard of rules and regulations," could be simultaneously subject to the negligence penalty and either the overvaluation penalty or the substantial underpayment penalty. Similarly, conduct that is fraudulent can be subject to both the fraud penalty and the substantial understatement penalty, with the total penalty exceeding 100% of the understated taxes.

The current negligence penalty is not "item specific"; that is, it is not limited to the portion of the underpayment attributable to negligence, but is based on the entire deficiency. As a result, the negligence penalty can vary from taxpayer to taxpayer for the same conduct and, in certain circumstances, could even exceed the penalty that would be imposed if the same item were fraudulent.

INTEREST AND INTEREST COMPONENTS

The basic interest rate on tax deficiencies was unchanged, at 6 percent, from 1921 to 1975. In 1975 and again in 1981, Congress increased the interest rate. Also in 1981, Congress began incorporating additional interest components in the penalties themselves. At present, the Code has a regular interest provision, an interest component of the fraud penalty, an interest component of the negligence penalty, enhanced interest on certain tax motivated transactions, and two different rules for imposing interest on penalties.

SUMMARY OF RECOMMENDATIONS

The Task Force has concluded that the general taxpayer penalty provisions should be retained, but modified. A two-tiered negligence penalty would replace the existing negligence penalty. The new negligence penalty would be "item specific; that is, it would apply only to the specific portion of an understatement attributable to negligence. The higher rate would apply to intentional conduct and the lower rate to conduct which was merely careless.

The overvaluation penalty, Section 6659, would be eliminated as redundant and unnecessarily complex.

There is disagreement over the substantial understatement penalty. The predominant view was that the substantial understatement penalty, like the overvaluation penalty, should be eliminated. In short, it was felt that a broad-based negligence penalty would apply to the same conduct and would be sufficient to deter the misbehavior without necessity of multiple overlapping penalty provisions.

The minority view favored retention of the substantial understatement penalty, but with amendments to clarify its scope and application and to coordinate it with the negligence and fraud penalties so as to eliminate pyramiding.

The Task Force felt that certain express or implied presumptions in the penalty system are undesirable for various reasons. For example, we do not believe that a "no fault" penalty should be imposed merely because the tax deficiency exceeds certain mathematical limits. A deficiency may arise as the result of mistake or accident involving no misconduct by a taxpayer.

In addition, where any portion of an understatement is shown to be attributable to fraud, it is presumed that all the understatement is also attributable to fraud, unless the taxpayer shows to the contrary. We believe this presumption is inappropriate and unfair. We also oppose the presumption of negligence where the taxpayer fails to report an information item.

We have made recommendations which would coordinate the delinquency penalties with the fraud, negligence and (if retained), substantial underpayment penalties. We have recommended the elimination of the interest components of the fraud and negligence penalties, and the interest enhancement provision which applies to deficiencies arising from tax motivated transactions. It is believed that a proper basic rate for a penalty, coupled with ordinary interest provisions, is adequate to deter sanctioned conduct. Finally, as a matter of perceived fairness, there should not be an interest differential between the interest rate the taxpayer must pay to the government on an understatement and the amount he receives where he is entitled to a refund.

I have attached an outline of the Basic Understatement Penalty Components and Interest Components of the Understatement Penalties.

BASIC UNDERSTATEMENT PENALTY COMPONENTS

CODE SECTION	TITLE	DESCRIPTION	PROPOSED CHANGES
§ 6653(b)(1)	Fraud	75% of the portion of the understatement attributable to fraud.	Presumption of fraud repealed.
§ 6653(a)(1)	Negligence	5% of the entire understatement for a timely filed return or 5% of the total corrected tax on a late filed/or unfiled tax return.	Two tier penalty: (1) 50% of the portion of the understatement attributable to reckless or intentional conduct, and (2) 25% of the portion of the understatement attributable to simple negligence or carelessness.
§ 6661	Substantial	25% of the understatement attributable to a "substantial understatement."	Repealed or substantially revised.
§ 6659	Overvaluation	Where overstatement of basis or value of an asset results in an understatement of tax of at least $1,000: Overvaluation — Penalty 150-200% — 10% Over 200-250% — 20% Over 250% — 30% Contribution 150% and over — 30%	Repealed.
§ 6651(a)(1)	Failure to File	5% per month, maximum 25%, computed on balance due.	Coordinated with the negligence (and substantial understatement) penalty to eliminate overlapping. Where taxpayer's sole misconduct is the failure to timely file there would be a delinquency penalty but no negligence (or substantial understatement) penalty. The negligence (substantial understatement) penalty would apply to the actual understatement of tax on the delinquently filed return.
§ 6651(a)(2)	Failure to Pay	0.5% per month, maximum 25%.	No change.

INTEREST COMPONENTS OF THE UNDERSTATEMENT PENALTIES

CODE SECTION	TITLE	DESCRIPTION	PROPOSED CHANGES
§§ 6601(a), 6621 and 6622	Regular Interest	Short-term Federal rate plus 3 percent, compounded daily, non-deductible.	No change.
§ 6653(b)(2)	Fraud Component Based on Interest	Additional amount equal to 50% of the interest on the fraudulent portion of the understatement.	Repealed.
§ 6653(a)(2)	Negligence Component Based on Interest	Additional amount equal to 50% of the interest on the negligent portion of the understatement.	Repealed.
§ 6601 (a)(2)(A)	Interest on Penalties in General	Interest on penalties (other than IRC 6651(a)(1), 6659, 6660, and 6661 penalties) will be imposed from the date of notice and demand if not paid within 10 days of notice and demand.	No change.
6601(a)(2)(B)	Interest on Certain Penalties	Interest on IRC 6651(a)(1), 6659, 6660, and 6661 penalties will begin on the date the return is required to be filed (including extensions).	Interest on all taxpayer penalties, including fraud and negligence, runs for 10 days after notice and demand.
§ 6621(c)	Enhanced Interest on Tax Motivated Transactions	The regular interest rate is increased to 120% where underpayment exceed $1,000 as the result of certain tax motivated transactions.	Repealed.

Example of Application of Ad Valorum Penalties

Mr. X, a single individual taxpayer, engaged in a sham transaction in 1987 whereby his deprecible basis in an asset was artificially increased from $100,000 to $300,000. Whereas, Mr. X was entitled to depreciation deductions of $10,000, he claimed $30,000 on his 1987 return attributables to the claimed increased basis. Mr. X also failed to report $5,000 of interest income and had $15,000 in deductions disallowed for lack of substantiation. Mr. X, without these adjustments reported taxable income of $50,000 on his 1987 return filed five months late.

Reported on Return	$50,000
Adjustments	
Depreciation	20,000
Interest	5,000
Other Deductions	15,000
Correct Taxable	$90,000

If Fraud Proven

Deficiency =	$13,260	
Fraud (Depreciation Only)		5,775+interest
Delinquency (on 70,000)		5,228
Negligence (on 70,000)		1,045+interest
Other valuation		2,310
Understatement (adjusted for 6659)		1,890
		16,248+interest

If No Fraud Proven

Deficiency =	$13,260	
Fraud		-0-
Delinquency (on 90,000)		7,153
Negligence (on 90,000)		1,430+interest
Overvaluation		2,310
Substantial Understatement		1,890
		12,783+interest

EXAMPLES

A. Taxpayer A, an individual who is in a 50% tax bracket, makes a charitable contribution of property (held for three years) and takes a deduction of $600,000. His valuation of the property is based upon a statement made by a representative of the donee, who was not a qualified appraiser. The IRS determines the correct value of the property to be $400,000. A $160,000 deficiency is assessed, $100,000 of which is due to the overvaluation. Since the tax required to be shown on Taxpayer A's return was $284,000, the understatement due to the overvaluation also qualifies as a substantial understatement.

1. Tax Year 1969: There was no overvaluation or substantial understatement penalty.

If the taxpayer settles the case after 1 year (on April 15, 1971), the amount due is:

Tax Deficiency	$160,000
Interest on Deficiency (1 yr. at 6%)	9,600
	$169,600

If the taxpayer settles the case after 3 years (on April 15, 1973), the amount due is:

Tax Deficiency	$160,000
Interest on Deficiency (3 yrs. at 6%)	28,800
	$188,800

If the taxpayer settles the case after 5 years (on April 15, 1975), the amount due is:

Tax Deficiency	$160,000
Interest on Deficiency (5 yrs. at 6%)	48,000
	$208,000

2. Tax Year 1980: Assume taxpayer files a timely return on April 15, 1981 and a Notice of Deficiency is issued on October 15, 1981. There was no overvaluation or substantial understatement penalty, and neither fraud nor negligence is implicated here. Since this qualifies as a tax-motivated underpayment, the applicable interest rate after December 31, 1984 is 120% of the adjusted rate.

If the taxpayer settles after 1 year (on April 15, 1982), the amount due is:

Tax Deficiency	$160,000
Interest on Tax Deficiency (1 yr. at simple 12%, 20%)	21,791
	$181,791

If the taxpayer settles after 3 years (on April 15, 1984), the amount due is:

Tax deficiency	$160,000
Interest on Tax Deficiency (3 yrs. at simple 12%, 20%, compound 16%, 11%)	81,502
	$241,502

If taxpayer settles after 5 years (on April 15, 1986), the amount due is:

Tax Deficiency	$160,000
Interest on Tax Deficiency (5 yrs. at simple 12%, 20%, compound 16%, 11%, 13%, 10%)	142,787
	$302,787

3. Tax Year 1984. Assume Taxpayer A timely files a return on April 15, 1985, and a Notice of Deficiency issues on October 15, 1985. Since Taxpayer A is an individual, and the claimed valuation of the property is more than 150% of the actual value, an overvaluation penalty of 30% of the underpayment due to the overvaluation of a charitable contribution is imposed, that is, $30,000. There was no qualified appraisal and taxpayer failed to make a good faith investigation of the value; consequently, the penalty will not be waived. In addition, a substantial penalty of 10% of the underpayment is imposed on the $60,000 of the understatement which is not already penalized as an overvaluation. Moreover, the portion of the deficiency due

to the overvaluation, a tax-motivated substantial understatement, is subject to interest at 120% of the adjusted rate.

If taxpayer settles after 1 year (April 15, 1986), the amount due is:

Tax Deficiency	$160,000
Overvaluation Penalty (30% of portion due to overvaluation ($100,000)	30,000
Substantial Understatement Penalty (10% of remaining $60,000 portion)	6,000
Interest on $100,000 Tax Deficiency Due to Overvaluation (1 yr. at 120% of assumed adjusted rate of 9% compounded)	11,345
Interest on remaining $60,000 Tax Deficiency) (1 yr. at assumed 9% compound rate)	5,647
Interest on $30,000 Overvaluation Penalty (1 yr. at assumed 9% compound rate)	2,823
Interest on $6,000 Substantial Understatement Penalty (1 yr. at assumed 9% compound rate)	566
	$216,381

If taxpayer settles after 3 years (on April 15, 1988), the amount due is:

Tax Deficiency	$160,000
Overvaluation Penalty	30,000
Substantial Understatement Penalty(10% of $60,000)	6,000
Interest on $100,000 Tax Deficiency Due to Overvaluation (3 yrs. at 120% of assumed 9% adjusted rate)	37,745

Interest on $60,000 Remaining Tax Deficiency (3 yrs. at assumed 9% adjusted rate)	18,586
Interest on $30,00 overvaluation Penalty (3 yrs. at assumed 9% rate)	9,292
Interest on $6,000 Substantial Understatement Penalty (3 yrs. at assumed 9% rate)	1,859
	$263,482

If taxpayer settles after 5 years (on April 15, 1990), the amount due is:

Tax Deficiency	$160,000
Overvaluation Penalty (30% of $100,000)	30,000
Substantial Understatement (Penalty (10% of $60,000)	6,000
Interest on $100,000 Tax Deficiency Due to Overvaluation (5 yrs. at 120% of assumed adjusted rate of 9% compounded)	71,137
Interest on Remaining $60,000 Tax Deficiency (5 yrs. at assumed compound rate of 9%)	34,074
Interest on $30,000 Overvaluation Penalty (5 yrs. at assumed compound rate of 9%)	17,036
Interest on $6,000 Substantial Understatement Penalty (5 yrs. at assumed compound rate of 9%)	3,407
	$321,654

4. Tax Year 1987: The Tax Reform Act of 1986 raised the substantial understatement penalty to 25%. Assume the return is timely-filed on April 15, 1988 and the Notice of Deficiency issues October 15, 1988.

If taxpayer settles after 1 year (April 15, 1989), the amount due is:

Tax Deficiency	$160,000
Overvaluation Penalty (30% of $100,000 portion due to overvaluation)	30,000
Substantial Understatement Penalty (25% of remaining $60,000 portion)	15,000
Interest on $100,000 Tax Deficiency due to Overvaluation (1 yr. at 120% of assumed adjusted rate of 9% compounded)	11,345
Interest on remaining $60,000 Tax Deficiency (1 yr. at assumed 9% compound rate)	5,647
Interest on $30,000 Overvaluation Penalty (1 yr. at assumed 9% compound rate)	2,823
Interest on $15,000 Substantial Underpayment Penalty (1 yr. at assumed 9% compound rate)	1,412
	$226,227

If taxpayer settles after 3 years (on April 15, 1991), the amount due is:

Tax Deficiency	$160,000
Overvaluation Penalty	30,000
Substantial Understatement Penalty	15,000
Interest on $100,000 Tax Deficiency due to Overvaluation (3 yrs. at 120% of assumed 9% adjusted rate)	37,745
Interest on $60,000 Remaining Tax Deficiency (3 yrs. at assumed 9% compound rate)	18,586
Interest on $30,000 Overvaluation Penalty (3 yrs. at assumed 9% compound rate)	9,292
Interest on $15,000 Substantial	4,647

Understatement Penalty (3 yrs. at assumed 9% compound rate)	
	$275,270

If taxpayer settles after 5 years (on April 15, 1993), the amount due is:

Tax Deficiency	$160,000
Overvaluation Penalty	30,000
Substantial Overstatement Penalty	15,000
Interest on $100,000 Tax Deficiency due to Overvaluation (5 yrs. at 120% of assumed 9% adjusted rate)	71,137
Interest on Remaining $60,000 Tax Deficiency (5 yrs. at assumed 9% compound rate)	34,074
Interest on $30,000 Overvaluation Penalty (5 yrs. at assumed 9% compound rate)	17,036
Interest on $15,000 Substantial Understatement Penalty (5 yrs. at assumed 9% compound rate)	8,519
	$335,766

B. Assume that the IRS determines that Taxpayer A was negligent in relying upon the valuation made by a representative of the donee. The following negligence penalties, based upon the $100,000 deficiency due to negligence, are assessed in addition to the overvaluation and substantial understatement penalties.

1. Tax Year 1969:

If the taxpayer settles the case after 1 year (on April 15, 1971), the additional amount assessed due to negligence is:

Negligence Penalty (5%)	$5,000
Interest on Penalty (6 mo. at 6%)	150
	$5,150

If taxpayer settles after 3 years (on April 15, 1973), the additional amount assessed due to negligence is:

Negligence Penalty	$5,000
Interest on Penalty (2 1/2 yrs. at 6%)	750
	$5,750

If taxpayer settles after 5 years (on April 15, 1975), the additional amount assessed due to negligence is:

Negligence Penalty	$5,000
Interest on Penalty (4 1/2 yrs. at 6%)	1,350
	$6,350

2. Tax Year 1980 (pre-ERTA, TEFRA): The return is timely filed April 15, 1981. A Notice of Deficiency issues October 15, 1981.

If taxpayer settles the case after 1 year (on April 15, 1982), the additional amount due to negligence is:

Negligence Penalty (5%)	$5,000
Interest on Penalty (6 mo.	380

at 12% and 20%)	
	$5,380

If taxpayer settles the case after 3 years (on April 15, 1984, the additional amount due to negligence is:

Negligence Penalty (5%)	$5,000
Interest on Penalty (2 1/2 yrs. at 12%, 20%, and compound 16%, 11%)	2,195
	$7,195

If taxpayer settles after 5 years (on April 15, 1986), the additional amount due to negligence is:

Negligence Penalty (5%)	$5,000
Interest on Penalty (4 1/2 yrs. at simple 12%, 20%, compound 16%, 11%, 13%, and 10%)	4,028
	$9,028

3. Tax Year 1984 (post-ERTA, TEFRA): Assume that the same return is timely filed on April 15, 1985 and the Notice of Deficiency issues October 15, 1985. The additional 5% negligence penalty is now accompanied by a further penalty of 50% of the interest on the understatement due to negligence.

If taxpayer settles the case after 1 year (on April 15, 1986), the additional amount assessed due to negligence is:

Negligence Penalty (5%)	$ 5,000
50% of the Interest Negligence Penalty (Negligent understatement = $100,000. Interest on $100,000 for	4,707

1 year at assumed 9% compound rate = $9,415. Assume date of assessment is date of payment.)	
Interest on Penalty (6 mo. at assumed 9% compound rate)	448
	$10,155

If taxpayer settles the case after 3 years (on April 15, 1988), the additional amount due to negligence is:

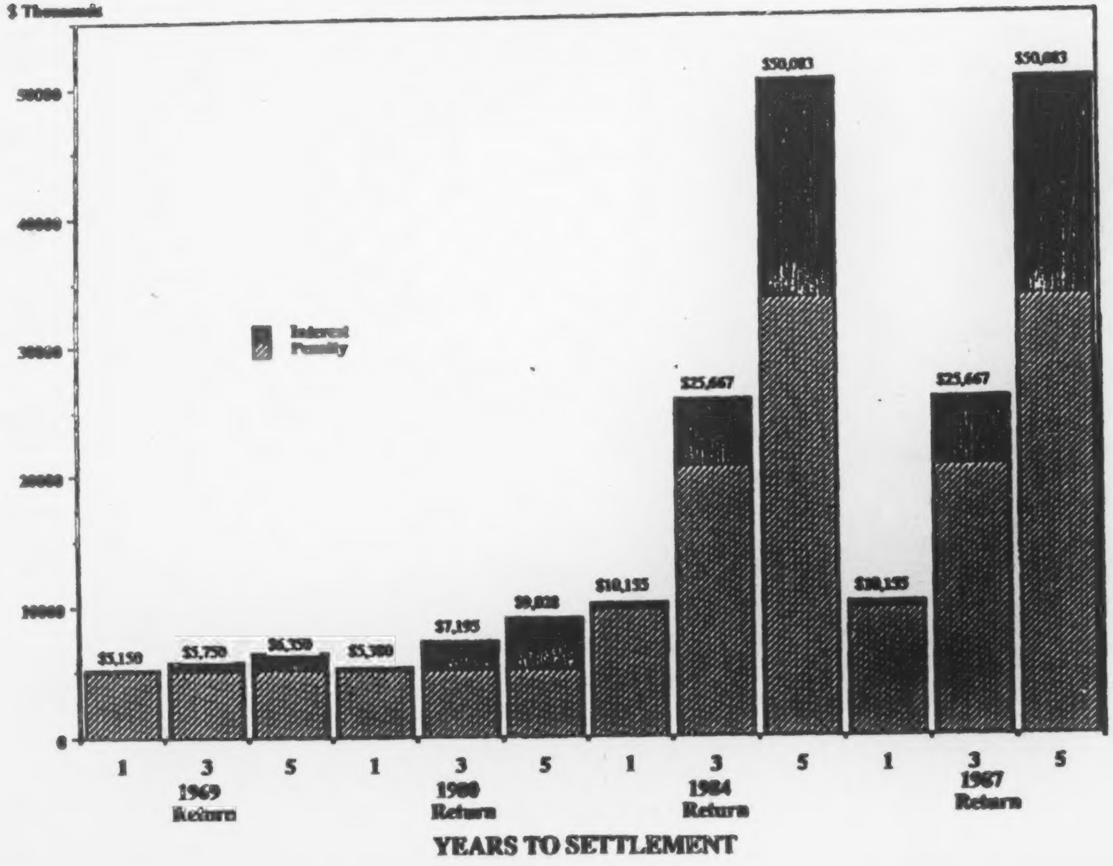
Negligence Penalty (5%)	$ 5,000
50% of the Interest Negligence Penalty (Interest on $100,000 for 3 yrs. at assumed 9% compound rate = $30,987)	15,494
Interest on Penalty (2 1/2 yrs. at assumed 9% compound rate)	5,173
	$25,667

If taxpayer settles the case after 5 years (on April 15, 1990), the additional amount due to negligence is:

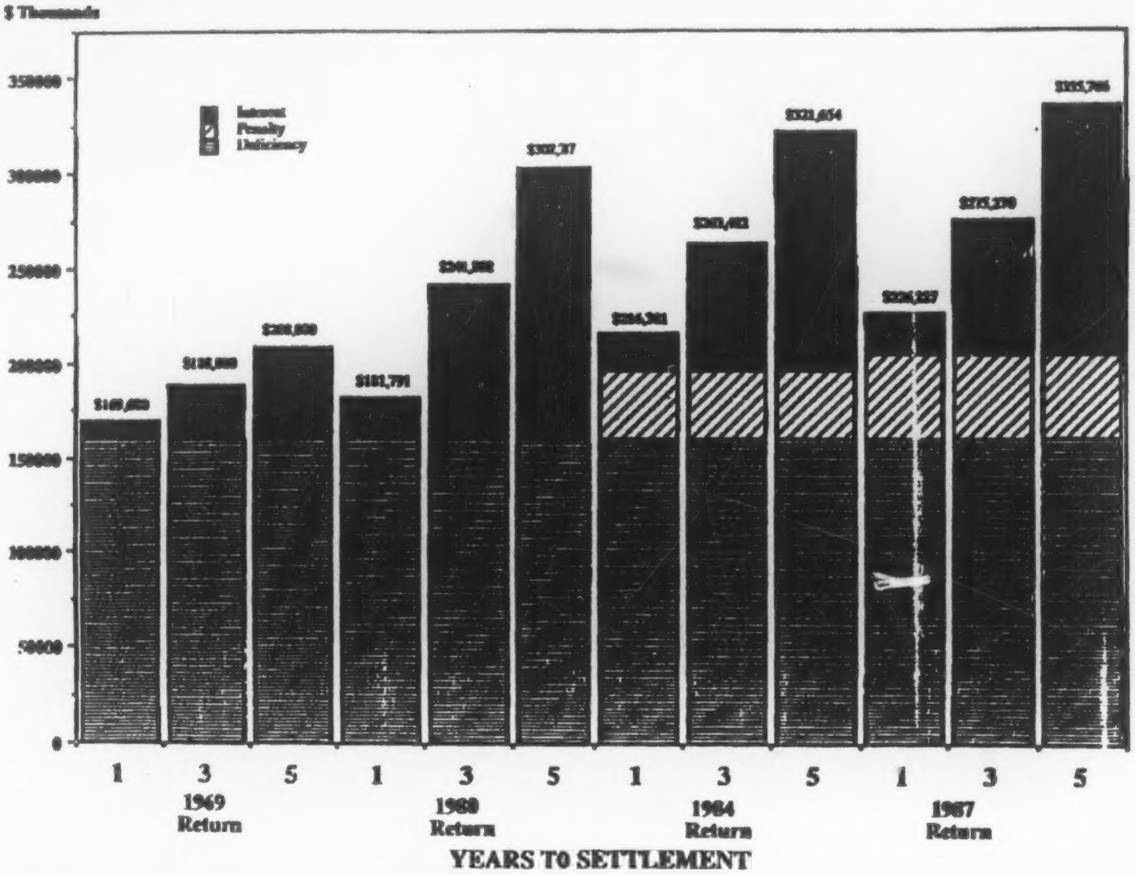
Negligence Penalty (5%)	$ 5,000
50% of the Interest Negligence Penalty (Interest on $100,000 for 5 yrs. at assumed 9% compound rate = $56,812)	28,406
Interest on Penalty (4 1/2 yrs. at assumed 9% compound rate	16,677
	$50,083

4. Tax Year 1987 (post-Tax Reform Act of 1986): The negligence penalties were not changed. Consequently, Taxpayer's position remains the same as for tax year 1984.

NEGLIGENCE PENALTY
(On $100,000 Deficiency)



OVERVALUATION PENALTY



Chairman PICKLE. We thank you. Now we will proceed with Mr. Merritt.

STATEMENT OF JAMES E. MERRITT, MEMBER, SECTION OF TAXATION, AMERICAN BAR ASSOCIATION

Mr. MERRITT. Thank you, Mr. Chairman and subcommittee members. I am a subcommittee chair on this ABA task force and I was a former chairman of the ABA's committee of administrative practice of the tax section back in 1980 and 1982, the timeframe when many of these penalties were being drafted and enacted.

I have two major points I would like to address: One, is to discuss the task force report with regard to third-party penalties, second, is to present the minority view with regard to taxpayer penalties, principally the substantial understatement penalty.

The good news is that with regard to third-party penalties, they seem to be working relatively well. Now bear in mind that there is a very short period of experience with regard to a great many of those penalties, many of which were enacted in the mideighties.

These penalties were to address two different types of activities. One, what we would consider people that were really trying to damage the tax system. These are your abusive tax shelters and tax protesters. And second, to bring a degree of standard of care, so to speak, to the industry that specializes in advising taxpayers and so-called tax return preparers. The experience with tax return preparers dates back to 1976.

The good news is that tax shelters and the tax protester movement seems to be on the decline. We cannot attribute that all to the penalty structure that has been put in place because Congress made many changes in the substantive tax law during the same time period, and the IRS has adopted an increased enforcement practice and the courts have been, I guess, very supportive of that practice during the last 5 years as well. So all three of these types of activities, I believe, have succeeded in reducing the tax shelter activity and the tax protester movement.

We do have some specific recommendations with regard to some of the tax shelter penalties, specifically section 6700. There is a controversy in the courts as to how to compute the amount of the penalty, whether it is a maximum of $1,000 per sale or per year. We think Congress could clarify that one very quickly and it would save some years of litigation which might even go up to the U.S. Supreme Court and there is no need for that.

The other thing is, there is no statute of limitations on the section 6700 penalty. We do not think that selling an abusive tax shelter is quite as bad as fraud or murder. We think there should be some statute of limitations and we recommend 5 years.

The tax return preparer penalties which were enacted in 1976, I think illustrate a point I would like to emphasize. That is, in enacting penalties and in administering penalties, both Congress and the Service should be aware of the willingness of tax advisors as well as taxpayers to comply. Sometimes we overlook that and think that you have to hit them over the head with a club to get them to do something you want them to do and that is not entirely true. Sometimes you just have to tell them what it is you want them to do.

I say the preparer penalties illustrate that very well because when it was enacted in 1976 and for the following 4 years, there was no guidance provided by the IRS as to how preparers could adopt procedures to eliminate negligence in their preparation of tax returns. That is the major penalty that has been applied to preparers. There was a lot of controversy. In those years, the numbers of penalties being assessed was up at a 33,000 to 34,000 per year level.

In 1980, as a result of a good deal of discussion with the preparer industry, the Service published a series of revenue rulings and a revenue procedure which set forth very adequate guidelines, such that today the discussion in the industry, which you get from Law Review articles and we have cited several of them, is that there is no reason why any tax return preparer should be subject to the negligence penalty because they can follow the IRS guidelines, adopt what is called normal office procedures and avoid the negligence penalty.

What you have there is not somebody getting around the law. You have compliance. By giving a willing group of people guidelines by which they can comply, you have achieved the goal. As a result, you can see the numbers of violations—the times that penalties have been assessed—has dropped off dramatically by a couple of hundred percent subsequent to the 1980 issuance of guidance.

We think the IRS should do more of that. It does not apply to everybody. I do not think it would have applied to tax shelter promoters necessarily because they were out to get some money and run. I am not sure it would apply to the tax protester movement. But to the vast majority of small business taxpayers, for example, which you heard something about earlier this morning, as well as to any persons who are involved professionally in advising taxpayers, I think guidance is the answer.

That would be particularly appropriate in the aiding and abetting penalty which may be applied to advisers and tax return preparers as well. I should note in passing, however, that thus far even though technically it could be applied to those people, it has only been applied to the protest movement type of person.

The other major point with regard to preparer penalties, and it relates also to the shelter penalties, is that you need to take into account the degree of severity, what penalty rate you want to have. Our report is based upon the existing law. But there are some troublesome things. For example, the fraud penalty—this is when a preparer has willfully violated the rules in advising a taxpayer—the fraud penalty is $500. The negligence penalty is $100. Those seem to be very low. Indeed, if that was the only penalty involved on preparers, you would not have people being very concerned about it.

The way that those penalties are being implemented, in fact at the present time, is that they generate a referral to the director of practice of the Treasury Department who then may institute proceedings to suspend or disbar a tax return preparer and prevent him from continuing with his livelihood if he has been subject to many of those penalties. You may want to look at whether the amounts are adequate and whether or not you should consider a review of the disciplinary proceedings conducted by the director of practice.

Let me turn now to the minority view in the task force report. By and large, there is general agreement with regard to the need to make modifications in the substantial understatement penalty of section 6661. The minority view is simple, the negligence penalty as we know it and love it is working pretty well today, why tinker with it.

Specifically, why make it a specific item type of penalty. When you do that, you have introduced a level of complexity into administering the laws that I am not sure is worth it, frankly. Especially, when you have got a concept that the courts, taxpayers and tax lawyers know and have used for a long time. The example Mr. Saltzman talked about is an isolated incident. It technically can happen. It actually does happen. It is the type of thing where the discretion of the prosecutor should avoid that kind of unfair result. That may be the way to solve it as opposed to adding a great deal of complexity.

Partly for that reason and partly because I worked on drafting and working with the people who were drafting the substantial understatement penalty—and I work with it every day in my practice—I believe it works. I think the substantial understatement penalty is understood by everybody in the tax profession right now. The concept of substantial authority I do not find to be difficult to understand. It is true it is no more defined than negligence, but negligence is understood by people. Substantial authority is understood by people, too, today. That is one basic concern I have with the majority report. Let me just give an example or two, that I think will illustrate the problems that are being missed there.

Prior to enactment of section 6661, I am familiar with a situation where a taxpayer asked to take a $50 million deduction. The question was not whether or not that was correct, it was whether it would be negligent. If it were not negligent, then the taxpayer could earn several millions of dollars, even though the IRS would audit and identify the issue and the taxpayer would concede the issue.

Now you have done two things since that time that have really changed the ballgame. One is, you have gone to a commercial interest rate, and that is very important to do. The second thing is, you put in a downside risk, and that is the substantial understatement penalty. At the time it was enacted it was 10 percent, which I tend to think is a more proper level for it than the current 25 percent. So you do not have that same situation coming up today. That taxpayer today knows, number one, that if he loses he is not going to have the interest rate arbitrage advantage that he used to have. No. 2, he is going to have to pay a 25 percent, or 10 percent, penalty for taking that aggressive position. You have changed that.

The thing I see currently, and you are missing the point, I think, if you do not believe and realize, there is a marketplace out there that you are trying to control. There is a marketplace in selling tax savings ideas. Clients I work with are approached almost weekly by various people coming up with one proposal or another that will save them millions of dollars.

After the enactment of section 6661, these people have to tell those clients whether or not there is substantial authority for their position. The client is not going to buy it unless there is. What you have done by enacting the substantial understatement penalty and the substantial authority concept is you have upped the level of the playing field. If you eliminate it, you are going to reduce it right back down to where everything that people will be asking is, will this avoid fraud or will this avoid negligence.

I submit the substantial authority standard is a healthy one. That means you have got to have a fairly high degree of authority for your position. You cannot just say, this is good enough—I can go in before the committee or before the court and I will not have to laugh when I state the position. I can say it seriously, and I have got other people that agree with me, and courts or rulings from the IRS that agree with me.

Although I am supportive of the substantial understatement penalty, I certainly believe it should be modified. The biggest problem with it is that there is an unrealistic definition of what constitutes authorities in the regulations which have been adopted.

Every day, in my practice—and I know it is true of people in government practice as well—when we try to interpret the tax laws, we will look not just at the statute and the regulations and the court cases, but we look at proposed regulations, we will look at written determinations that have been issued by the IRS, we will look at the "Blue Book" put out by the Joint Committee, and we will consider all of those things and try to interpret what is a complex and a very big statute. There are a lot of times when you do not find regulations and you do not find court cases, so the major things that you have to look to are what you think Congress meant and what you think the IRS believes is the case.

Now, none of those things are considered to be authorities by the IRS, not proposed regulations, not written determinations which they have issued, nor the Blue Book. That is just plain unfair. There is no other way to say it. It is just totally improper to penalize a taxpayer for interpreting the tax law the same way the IRS has in a proposed regulation. I see no justification for it and I have not since the statute was adopted or regulations published, and that should be changed.

The second thing is that these penalties should be coordinated with other penalties, so that no other penalties are imposed for the same conduct. We have I think an egregious situation that is developing now with regard to the lack of coordination between the substantial understatement penalty and the delinquency penalty.

If you file a correct return, if you file it late, I submit that it should be subject to the delinquency penalty only. That is the only thing you have done wrong. If you file a late return and there is also a substantial understatement on that return, then you ought to be subject to both penalties.

The problem is that there are interpretations by the IRS that if you file a late return, even though it is correct, that is a per se substantial understatement, and I do not see any justification for that in the statute or in logic, to be honest with you.

Those are the major points of disagreements and the major points of clarification that I believe should be made in the substantial understatement penalty.

I appreciate the opportunity to appear before you today and I will be happy to answer any questions.

[The statement of Mr. Merritt follows:]

JAMES E. MERRITT
PENALTIES TASK FORCE
SECTION OF TAXATION
AMERICAN BAR ASSOCIATION

Mr. Chairman and Members of the Committee:

INTRODUCTION

I am James E. Merritt, San Francisco, California, a subcommittee chair of the Penalties Task Force. I am a member of the Administrative Practices Committee.

I will respond to the recommendation made by the Task Force for repeal of the substantial understatement penalty. My statements express the minority view that the substantial understatement should be modified and retained. I will also outline the Task Force recommendations concerning the third party bad conduct penalties.

SUBSTANTIAL UNDERSTATEMENT PENALTY

In 1982, Congress enacted the substantial understatement penalty. The penalty applies where an understatement of tax exceeds the greater of $5,000 or 10 percent of the correct tax due. The substantial understatement penalty is considered to be a modified no fault penalty. That is, it applies without regard to a determination of actual misconduct by the taxpayer. If a substantial understatement exists, a penalty equal to 25 percent of the understated tax is imposed. However, the penalty does not apply if the taxpayer (1) had "substantial authority" for his position, or (2) in non-tax shelter cases, adequately disclosed on the return facts relevant to the tax treatment of the particular item. The Internal Revenue Service has also adopted regulations which permit the administrative waiver of the penalty based upon a showing of reasonable cause for the understatement and good faith.

I agree with the majority that the present substantial understatement provision contains significant flaws. However, I disagree that these problems can only be remedied with the elimination of the penalty. The appropriate legislative action is to revise Section 6661.

The substantial understatement penalty should not be repealed. Absent this penalty, the Code would fail to sanction against aggressive positions short of negligence, with the exception of interest on the deficiency. Eliminating this penalty would greatly diminish taxpayer motivation to disclose aggressive positions supported by an opinion of counsel. Taxpayers would, in effect, be invited to return to the "race to the bottom" in advisory opinions. This "race" was the activity which demanded Congressional action in the first place. Therefore, repealing this provision would be counter to the original goals of Congress.

While there is disagreement as to whether or not this penalty should be repealed, there is substantial agreement on the Task Force that the penalty, if retained, should be substantially modified. First, members are in accord that a 25 percent "no fault" penalty is inappropriately high. "Aggressive reporting" resulting in a substantial understatement falls short of negligence, yet the penalty is five times the rate of the negligence penalty. A sense of proportionality and fairness suggests that the substantial understatement penalty be levied at a rate that would be less than the minimum rate imposed with respect to the fault based negligence penalty. In this manner, the penalty rates would be proportionate to the taxpayer's culpable conduct. Second, it is not necessary to have a special provision for tax shelters, since tax shelters are virtually obsolete by virtue of the 1986 Act. Finally, there is a general consensus that the disclosure exception should be retained.

To achieve an effective and fair substantial understatement penalty, Section 6661 must first undergo several revisions. I submit the following recommendations:

(1) The term "authority" should be broadened to include proposed regulations, written determinations such as private rulings, and the "blue book." These sources of information are often used by the Internal Revenue Service in developing positions for other rulings and are also relied on by tax practitioners when advising clients. A definition of "authority" encompassing proposed regulations and private opinions would be consistent with legitimate tax practice and would give fair warning to those to whom this provision was meant to apply.

(2) The "substantial authority" standard should also be redefined. The provision should be revised to make clear that the penalty applies only where the taxpayer lacks "substantial legal authority." In other words, when the dispute is factual rather than legal, the substantial understatement penalty would not be applicable. This would tend to eliminate the overlapping of the substantial understatement penalty with the negligence penalty and it would avoid imposition of the penalty on taxpayers who have made a simple factual mistake.

(3) The substantial understatement provision should be transformed into a low rate (probably 5 percent) "no fault" audit charge (not a penalty) and the current "notch" effect should be eliminated by requiring that the charge be imposed only on the amount of deficiency which exceeds the greater of $5,000 or 10 percent of the correct tax.

(4) The substantial understatement should be coordinated with other civil penalties. Section 6661 should be amended to exclude from its application any portion of an understatement which has been subjected to a fraud or negligence penalty, and to eliminate duplication with the delinquency penalty. Coordination would avoid the serious and unnecessary pyramiding of penalties.

THIRD PARTY BAD CONDUCT PENALTIES

A section of the report analyzes and compares the provisions that apply to third parties to the tax system. These are the penalties that apply, for example, to unscrupulous tax return preparers and tax shelter promoters.

The third party penalties were first to the Internal Revenue Code beginning in 1976. These penalties addressed diverse actions by third parties and taxpayers which take advantage of the absence of sanctions and the difficulty of applying traditional civil and criminal fraud and negligence or intentional disregard penalties to third party conduct. The penalties include those for tax return preparers and advisers, promoters and others involved in preparation of abusive tax shelters, those who aid and abet the understatement of any tax liability and taxpayers who file frivolous returns or prosecute frivolous Tax Court proceedings.

The Task Force believes that there should be additional definition and coordination among the third party conduct penalties. Among the legislative changes would be revisions to Section 6700 which applies to promoters of abusive tax shelters, including principals, advisers and sales personnel. Section 6700 should be amended to specify that the penalty applies to each organization or sales activity engaged in by a promoter or by a salesman. The amount of the penalty, for conduct involving a gross valuation overstatement, should be $500. For statements involving false or fraudulent items, the penalty should be $1,000, which is comparable to the penalty imposed for knowingly aiding and assisting the understatement of a third party's liability. There should also be a five year limitation on the assessment and collection of a Section 6700 penalty. Finally, repeal may be warranted, since the 1986 Act has made tax shelters virtually obsolete.

Section 6701, which applies to those who aid and assist in the understatement of a third party's tax liability, should be amended to clarify that it reaches only conduct which affirmatively aids and assists or is meant to aid and assist in the preparation of a false or fraudulent document, moreover, it should be amended to provide that it is an exclusive remedy, so that it does not pyramid with the preparer penalties, Section 6694 and Section 6695.

The Task Force also believes that the partial payment refund remedies which are available under several sections of the Code, should be combined and the statute should be clarified to remove any uncertainty regarding the time when a notice of assessment is made and to make clear that a refund claim may be perfected by making payment in full.

Chairman Pickle. Thank you, Mr. Merritt.

I am having a little difficulty seeing on one sheet of paper what you are recommending. Each one of you testified for different categories. I have here now a kind of summary of your recommendations, and I have not had a chance to look over each one of them, which we will do.

You are recommending to us a three-tier system of taxpayer penalties be created, and that would go all the way, particularly for fraud, from 75 to 50 to 25 percent.

Now, on the surface of it, I ask myself the question: We are trying to simplify these 150 different kinds of penalties, and it would appear to me that at first brush you are recommending something that is going to be much more complex and technical than the general principles we are trying to follow here. What is your answer to that?

You say you are going to have penalties from 75, 50, or 25 percent, and in some cases we know it would go higher than the present tax, I am not so sure, but what you may be creating is something just as technical and just as complex. I do not make that statement as a judgment, but I am wondering, what do you say to that? I do not want to argue the point, but I just want your response to it.

Mr. Saltzman. The response is that the recommendation is part of an overall recommendation. The overall recommendation was to eliminate the substantial understatement penalty, so that would be removal of that bit of complexity.

Chairman Pickle. All right.

Mr. Saltzman. The standards of conduct are already in the code. In other words, fraud is there, that has been a traditional penalty, if you will. The common law negligence part is there.

What we thought was appropriate is this. Since right now intentional misconduct is lumped together with common law negligence, it does not make sense to punish that kind of conduct at a 5-percent penalty rate, when you are talking about an egregious kind of conduct.

So then you are left with the question, if you have different kinds of conduct, one type of conduct is clearly fraudulent, another type of conduct is intentional but something less than fraudulent, and a third type of conduct is something less than intentional conduct. This type of conduct would be negligence, and so it is appropriate to have three different penalties.

Now, those penalties, Mr. Chairman, are not penalties which have any hidden parts. In other words, the 75-percent penalty rate is a flat penalty, it applies to the fault based portion of the deficiency. The 50-percent intentional conduct penalty is a 50 percent, no other hidden features to it, and it applies to the fault based portion of the deficiency, and the same to the negligence.

Chairman Pickle. Mr. Saltzman, I do not think we need to argue the point, but out of the five former IRS Commissioners who testified to us earlier this year, I think all but one, or maybe all of them, testified that we ought to retain section 6661—that it is the very hallmark of our processing these tax returns. Their position is the opposite of yours with respect to that particular recommendation.

Is the position of the former Commissioners directly opposite to what you are recommending?

Mr. SALTZMAN. Well, let me address that, because I think it is an important point. There are differences of opinion about the substantial understatement penalty. It is clearly true that the substantial understatement penalty is kind of the darling of the Internal Revenue Service, because it is an automatic penalty. You do not have to think very hard, if you go over the threshold levels, you have got the penalty, period.

What has been successful about that penalty is this: More sophisticated taxpayers have gone to their advisors and, where controversial positions have been taken on a return, they have attached a so-called disclosure statement to the return. The disclosure procedure is the part of the penalty that has really worked well.

Our recommendation suggests, in fact, retaining the disclosure part of the substantial understatement penalty, not eliminating that part of the penalty, and adding it to the negligence penalty, so that people can advise the Service when they are taking a position that is controversial.

Chairman PICKLE. Here again, we do not have time to argue a lot of these points. How did you arrive at 75, 50 and 25 percent and say those are the figures? Did they just come out of the cloud as "X" factor or "G" factor?

Mr. SALTZMAN. We I think said in our report, and it is the case, these are obviously figures we have chosen for illustrative purposes. We are not wedded to 75, 50, and 25 penalty rates. We tried to utilize the code that exists for purposes of the fraud penalty rate, and as far as the floor was concerned, as far as the 25-percent negligence penalty was concerned, we used the benchmark of the delinquency penalty and, feeling that negligence was more egregious than mere delinquency, we felt that at least it should be the same amount. That is really how we did it.

Mr. MULLER. Mr. Chairman, may I make one comment about that?

Chairman PICKLE. Yes.

Mr. MULLER. Those numbers are not arbitrary. The 75-percent penalty exists in the code now. In the 1986 act, Congress proposed a 50-percent negligence penalty on specific items, so that 50-percent proposal came from the 1986 act, and the 25 percent is the present delinquency, so you already have those cuts in the code, 75, 50, and 25 as proposed.

Chairman PICKLE. I guess any figure we use would be arbitrary, unless we can base it on some study. Incidentally, I am questioning the American Bar panelists at this point, and I recognize that Mr. Portney and Mr. Smith have not testified and I want to get your testimony, but before this testimony gets cold, I thought we might proceed on that a little bit.

I have some additional questions also that I want to come back to, but before I continue, let me ask Mr. Shaw if he has any questions at this point.

Mr. SHAW. No.

Chairman PICKLE. Mr. Flippo.

Mr. FLIPPO. Mr. Chairman, I did have two or three questions, and I will be brief, in the interest of time.

I think, first of all, it was a very helpful study. Yours is the first that has come before the committee with specific recommendations, and I think it is going to play a very major role in helping to shape this discussion and debate.

All others, I think the chairman may be thinking about another hearing at some point in time, and I am sure your studies will be the ones that people will be examining and commenting on.

I guess one of the major areas of concern is this presumptive fraud recommendation that you are making, is a major change from current law. And I believe the thrust of your recommendation is that the presumptive fraud provision, section 6653(b)(2) should be eliminated, and you state that this presumption creates an unreasonable burden on the taxpayer and unnecessarily complicates and extends a proceeding regarding the taxpayer's liability.

I guess I would like to know a little bit more about how you determine that that would be the—why would that be an unreasonable burden on the taxpayer? As I understand current law, the IRS has to prove fraud. Once fraud is proven, the penalty is assessed against the entire understatement, but the taxpayer then has the authority to come back in and prove that certain areas or components of that total understatement were not a part of the fraud. Is that correct? Is that a correct interpretation of the current law?

Mr. MULLER. Yes, sir, that is correct.

Mr. FLIPPO. But you would recommend, then, that the IRS be required to prove fraud on each of the components. My question is what is wrong with the current theory that the taxpayer is in a better position to prove that fraud is not involved in those, as opposed to the IRS being required to prove that it is?

Mr. MULLER. There are three reasons why we feel that way. First of all, we feel that a fraud penalty of 75 percent is a very severe penalty, and that there ought not to be any presumption that someone is going to be subjected to a 75-percent penalty unless the Internal Revenue Service can show exactly what he did wrong and base that 75-percent penalty on what he did wrong. In other words, in the example we gave you, we had a $1,000 adjustment and a $30,000 no-fault adjustment. When we have such a high rate, we think the burden ought to remain with the Internal Revenue Service.

Second, the problem of the presumption is this: It is not clear under present legislation or in any case law exactly what a taxpayer has to do to overcome that presumption. Is it just that he must come forward with his own testimony and say this $30,000 item was not intentional on my part and not intended to be fraud, or must he go beyond that and meet a burden of clear and convincing evidence, which is suggested in our report as being the standard that could be applied under present law.

So I think the attitude is that with a high rate and with the unclear specification of what the burden is, that the presumption ought to be eliminated.

Mr. FLIPPO. If the rate were not 75 percent, would you have a different view on who ought to prove what?

Mr. MULLER. Well, in the practicality, it would mitigate my feelings about that. But in the practicality of the situation, the question in a courtroom of who throws the burden here and there is maybe esoteric, but I think it is real at the administrative level.

Mr. **Merritt**. Could I add a little comment there?

Mr. **Flippo**. Yes.

Mr. **Merritt**. Part of it is historical. You know, we used to have a 50-percent fraud penalty, and there the IRS had to prove some part of the understatement due to fraud and the penalty applied to the whole part. When it was changed, everybody thought they were getting a compromise. We would agree—we being the taxpayers and their representatives—to a higher rate if the IRS would agree to it being constrained to the fraudulent items, and what we find is with the presumptive burden of proof is that we have got the higher rate, but now it is the taxpayer who has got the burden to narrow down the scope of it, and we felt that was a little excessive.

Mr. **Flippo**. From an administration point of view, in your experience with the IRS, do you not have any concerns about the IRS' ability to—would this not just clog up the courts? I mean would you not in fact extend litigation with this kind of a recommendation, if this were adopted? Would you not be in court on every single component?

Mr. **Muller**. Mr. Flippo, I do not think so, because I believe that the IRS has the burden of proving, to assert this penalty, that something is fraudulent. Ordinarily, in making that proof, it would inherently identify what it is the taxpayer did that was fraudulent. In other words, I think it is highly unlikely that the IRS' proof as to the area of fraud would be so nonspecific that they could not identify what adjustment they were due.

Mr. **Flippo**. If I might just make this point: Does not the IRS have difficulty today in proving negligence in many cases?

Mr. **Muller**. Well, the IRS does not have to prove negligence. That burden is just presented to the taxpayer. In other words, that burden shifts. But the IRS does have to prove fraud to assess the 75-percent penalty.

Mr. **Flippo**. You had some comment, I believe, on the other point?

Mr. **Merritt**. Yes, sir. I am not much in favor of these specific item-type penalties. I think they add a lot of complexity, and I think, frankly, what we are having is that nobody is using it that way. In the typical civil fraud case, the taxpayer has already been convicted of criminal fraud or pled nolo, so the IRS has got, you know, it clearly established already that there has been fraud, and then they negotiate out kind of how much has been, the use of the fraud penalty today, and I do not think it has added a whole lot to the law, frankly, except a little bit of complexity.

Mr. **Saltzman**. I just would like to say that there is always a tradeoff. There is not going to be a perfect running machine, so far as the penalties are concerned.

What is more important, I think the identification of the fault-based portion of the deficiency is not so terribly complex, as it outweighs the appearance of fairness. Why should somebody be punished for a nonmisconduct based disagreement with the Service? Why should people wait until the end of the administrative process to find out really what the amount of the penalty is? Why should they be hit from behind by a penalty that is computed in such a way that you cannot readily determine the amount?

So there will be some complexity in any system that is adopted. Just on the fraud penalty point, I should say that in administrative practice, there usually is not confusion or lack of understanding about what is involved in a fraud penalty situation.

They are frequently cases that follow criminal cases, which are well-developed by the Service for prosecution purposes, and where they are not, the conduct is so egregious that in the course of the administrative process it is identified as this is the area which is fraudulent.

What the taxpayer has to do under the present system, however, is not merely prove or disprove the fraud, he has to prove that every item on the return is not fraud tainted, so that, if anything, the system now would lead to more litigation than a system that would be specific based.

Mr. FLIPPO. Mr. Chairman, I have many other questions, that in the interest of time I will forgo, but I just again want to commend the ABA on their strong efforts in this area.

Thank you.

Chairman PICKLE. Thank you, Mr. Flippo.

Now, Mr. Schulze, do you have any questions?

Mr. SCHULZE. Just very briefly. I thank the panel, Mr. Chairman, for their presentation. Many of you were in the room for the earlier discussion with the SBA, and I wanted to ask whether in your experience you had problems with the timely deposits with banks, with banks holding or abusing or playing games with the float, and whether this is a common problem or is it something rare and unique? Would any of you care to comment?

Mr. SALTZMAN. The employment tax penalties are not rare, they are not unique. They are a daily part of business life. What makes that daily bread, so to speak, a bit bitter is that, with the advent of computers and computerized or automated collection, a mistake is escalated into a catastrophe for a business person, with a levy on a bank account which is supposed to serve as the source for paying employees at the end of the week. So the proposition that was discussed, the possibility that was discussed of having that hold on collection is not merely a tinkering. It can mean the difference between life and death for a small business.

Mr. MERRITT. Could I respond to that, also?

Mr. SCHULZE. Sure, Mr. Merritt.

Mr. MERRITT. The reason I feel obliged to step in on that is I am the incoming chair of the Committee on Employment Taxes, so I am getting involved in this whole area quite a bit.

I have not seen anything or have heard anybody say that there is an abuse by the banks of the float on employment taxes. We do see lack of enforcement of the penalty that applies to lenders, section 3505, and we think if more use were made of that, that might relieve some of the pressure on small business employers, and implicitly in there is that there are times when if the bank is not primarily at fault, they are certainly sharing the fault.

I cannot leave the subject without saying that the AICPA and the IRS and the ABA had their second Compliance Conference in Crystal City about 3 months ago, and I think the major information that was shared there is that the biggest problem area in terms of compliance with the tax laws, putting aside people that are engaged in illegal activities, is small business and employment taxes. So I am not surprised that there is increased enforcement efforts by the IRS in that area.

Mr. **Schulze.** Do any of you care to address the question of taxpayer identification numbers in computers? It seems to me that there have been some problems where there was a major computer error that could cause all kinds of problems. It just seems to me that it is very difficult to draft legislation that says you have to be reasonable, because what is reasonable to somebody is not to someone else.

This is an area with an increased use of computers. We have to try to develop some reasonable guidelines. I would like your comments on that.

Mr. **Merritt.** In the information reporting areas, and I think fairly said, the IRS does get around to eliminating penalties on situations where their computer has been at fault. To some extent, fault can mean just delay. To some extent, they have the authority to abate or waive interest in those situations, but that is significantly limited and might apply really only to fairly ministerial acts by the Service that were improperly done, which I would think would cover most computer areas, and it is limited in amount.

I know of no client of mine that has not had a major computer problem with the IRS, and I am talking about significant payments of money that had been misplaced, the wrong year, the wrong service center by transfers, and we have spent probably on the average somewhere between 9 to 16 months in each instance to clarify those problems. I have even adopted hiring a person that used to be a collection officer for the IRS out on the west coast. He knows the computer codes, so he can locate somebody in the service center and figure out from their source documents, their keypunch documents where the errors were, and I can cut down solving these problems by about 80 percent. I can get them solved now in 1 to 2 months, because I hired this fellow who knows the keypunch codes and can correct them that way.

The IRS probably ought to rehire somebody like that and get them to work in the problem resolution officer program or the ombudsman program to solve these things, but it is a major concern and it irritates the taxpayers to no end.

Mr. **Schulze.** Do you find the problem resolution officers cooperative?

Mr. **Merritt.** Very much so. The problem resolution officer program should be emphasized more.

Mr. **Saltzman.** The point about these computer errors that has to be emphasized is that unless the system is turned off, unless somebody puts that hold on it, that is really the benefit of the problems resolution. The automated collection system and collection proceeds a pace, so if you are taking time to resolve the error and collection is proceeding, you are in trouble.

If you can get collection to stop and then resolve the error, I guess it is more tolerable.

Mr. **Schulze.** Thank you. Thank you, Mr. Chairman.

Mr. **Anthony.** Mr. Chairman.

Chairman PICKLE. Mr. Anthony, do you have a question?

Mr. ANTHONY. Thank you, Mr. Chairman.

My question is whether or not it is necessarily inappropriate for a taxpayer to be assessed a penalty which exceeds the tax liability, and, if so, why?

Mr. MULLER. Well, I will tell you why I think it is inappropriate. We have to be careful in this system of enforcement that we do not, as I would say, wash the taxpayer out. This guy who has done something wrong in the system has to remain in the system, pay the tax and penalty due, and be encouraged to comply in the future.

I think if the penalties get disproportionate or out of size, in other words, if you get to the point where you are going to hit him with 200, 300, and 400 percent, you are going to get first a problem of whether or not he can pay, and if he cannot pay, will that cause him to try to drop out of the system. And you are also going to get the problem of what does that do to his mentality, does he feel like when he is through that he was wrong, that he paid a fair amount of penalty for his error, for his stupidity or for his fault, and that he wants to get back in and make sure he does not do it again.

I mean part of this system has to be to rehabilitate and encourage the person to get back in. If it gets too high, I think the courts do not want to enforce it, the taxpayer will drop out, and he does not leave the system feeling like he was treated fairly.

Mr. ANTHONY. The other two witnesses, do they concur with that or have an additional comment?

Mr. MERRITT. I think Mr. Muller's last point is the one I concur with, that if you do not have a penalty that people and the courts view as being proportionate to the bad conduct, then it is not going to be enforced. We do have examples in false claims against the government and other types of situations which provide for treble damages. There are certain types of taxpayer conduct—filing a false refund claim, for example—that it is hard to say is really distinguishable as a category of conduct from false claims of another sort against the Government and hence they might be subject to the same penalty.

We did not look at the experience in applying treble damage-type penalties to Government claims generally to see how successfully they have been applied, so I cannot really comment as to whether that is a good idea, but there are certainly precedents out there that one could look to for a higher penalty level.

Mr. ANTHONY. Mr. Saltzman.

Mr. SALTZMAN. Yes. What we are concerned with in our report was articulating criteria, and one of the criteria that we thought should be adopted or considered is the criterion of a fair system, a penalty that is proportionate to the misconduct and a penalty system that would, as Chad has said, to educate the taxpayer to a distinction between bad conduct and good conduct.

If you have a penalty which is out of proportion, you are in effect going to leave the taxpayer at the end of the day, after he has been punished, with a feeling that the system has treated him unfairly, rather than with the recognition of the fact that what he did was wrong.

Mr. **Anthony**. So this recommendation, then, is based on your task force's feeling for what would be fair principles, rather than any type of factual study as to whether or not the system had been clogged up and that there had been numerous cases such as this?

Mr. **Saltzman**. Yes.

Mr. **Anthony**. So the numerical data would not change your viewpoint? This is a statement of principle?

Mr. **Saltzman**. There is no empirical data to support this. This is really basically from our experience in dealing with taxpayers who have been subjected to the penalties.

Mr. **Anthony**. Now, if penalty interest were eliminated, what incentive would taxpayers have for resolving their tax controversies in a timely manner?

Mr. **Muller**. Well, we do not recommend decreasing or eliminating the interest on penalties. However, there would not be an interest component buried in the penalty. In other words, the taxpayer would still be paying interest on his deficiency while it remains unpaid at the regular rate, which is substantial, plus he would pay interest on the penalty portion after notice and demand. There is a 10-day delay. So that would be in addition to the tax, and it would bear interest, too, so he still would have the plain old cost of money incentive to pay his taxes and the penalties, too.

Mr. **Anthony**. So, you do not recommend elimination of the interest?

Mr. **Muller**. We just recommend taking the little buried components out of the code and putting them in one place, and one interest provision, that is all.

Mr. **Anthony**. OK. Thank you.

I have one final area to get into, and this is a followup on what Mr. Flippo explored in the no-fault area. Have you had an opportunity through your task force to pull together any empirical data as to whether or not the no-fault penalties have increased the accuracy of the tax returns, or was your study basically put together, again, based on your statement of principles as to how you wanted to leave the taxpayer in his state of mind after he got through with this situation?

Mr. **Saltzman**. The substantial understatement penalty is a penalty that was adopted, I suggest, without a great deal of data to support it, and its present effect on the tax system is not supported by any or informed by any data.

There is anecdotal experience, and that I think was what gave the former commissioners their position before the committee, that people seem to be doing a better job in considering what kinds of positions to take on returns, because of the penalty which is automatically imposed unless there is substantial authority to support the position that is claimed. But the effect of that penalty is simply not clear.

What I can tell you that is clear is that once you get triggered, once there is a deficiency that exceeds the mathematical limits in the penalty, you automatically get that penalty and then you have to show why that penalty does not apply, and that is a reality of administrative practice now before the Service.

Mr. **Muller**. The substantial underpayment penalty was meant to focus on a particular type of conduct, that is, aggressive legal positions in a tax return. That, I submit to you, is only a very small portion of the taxpayer population that are taking aggressive legal positions. Most taxpayers are having problems just because they are not keeping records. Nevertheless, the penalty as presently constructed applies automatically to all ranges of conduct, even conduct that is essentially no fault and not based upon an aggressive legal position, which creates a situation like we had in the example where we did not talk about what the fault base was, but it could be just a factual fault or an inventory adjustment, where that penalty is going to be asserted to start off with, and that is one of the reasons why we think that that penalty should be eliminated and put over into the negligence penalty, and that is so that when a taxpayer is going to pay a penalty, there has been some preliminary determination of some fault.

Now, if he is taking a position, a legal position on his return that is aggressive, that would probably fall into the intentional conduct range of the negligence penalty as we proposed it, and there would have been a fault determination there.

Mr. MERRITT. I would like to add something there also, please, Mr. Anthony. We have looked in the Commissioners' annual reports and we have met with the IRS representatives and their task force, I believe on three occasions and are scheduled to meet with them in the future as well. I do not think there is any empirical data that anybody feels is big enough or reliable enough to draw any conclusions from about the 6661 penalty at this time. You have got to remember, it came in not so long ago and the audit delays, you do not start getting really good data for quite a few years after something like that is enacted, and this is something that really in terms of statistics you get from the IRS, you are going to need a 4 to 5-year lag before there has been enough audit experience. This is not going to be applied by the IRS prior to audit.

What we are seeing, though, in terms of both the conduct of taxpayers, preparers, advisors and the marketplace is very much as I described. There is no significant opinion that I give any client that does not have a discussion of the substantial understatement penalty in it. We talk about substantial authority, whether or not that is present, and if it is not present we talk about the need to make adequate disclosure and how that should be done, and that is required by the ABA standards of ethics now, so you have to deal with that opinion every day whenever the amount at issue that you are advising the taxpayer about is sufficiently large.

Taxpayers are very familiar with this penalty. I do not know of any significant corporation in this country that is not very well aware of the penalty and is going through this kind of analysis whenever it identifies an issue. I think people are concerned that there will be a clerical mistake and somebody will not identify an issue, and an honest mistake should not be subject to penalty. That was clearly one of the things that was discussed with Congress, at least the staff, as well as with the Service when the penalty was adopted, that you can have clerical mistakes. There is kind of a due diligence requirement, though. You cannot go around making million-dollar mistakes willy-nilly and contend that very many of them are clerical, or else you ought to be going out of business.

Mr. Anthony. Thank you very much. Thank you, Mr. Chairman. I yield back.

Chairman Pickle. Does anybody else have any questions?

Mr. Shaw. Mr. Chairman.

Chairman Pickle. Mr. Shaw, do you have a question?

Mr. Shaw. Being new on this committee and not having worked with these penalty provisions, I find myself trying to catch up and I shall not take the time of the committee to get educated as to exactly where these classifications are. However, I have a question which I believe is somewhat timely.

If a taxpayer were to file his 1987 tax return based upon a belief that a certain problem that he has is going to be taken care of in the Technical Corrections Act, and technical corrections does not pass, this I assume would be described as rather aggressive behavior. Now, would this fall into a classification of negligence, substantial unemployment, intentional disregard for the law? Where would this come in, and how would that decision be made?

Mr. Saltzman. Well, a position like that would, at the very least, would be subject to substantial understatement penalty, and the Service's interpretation of what that means does not include a projected or expected tax legislation. It would also seem——

Mr. Shaw. I would have to get in here and describe whether it was a technical correction—whether that is a substantive legislation change or not.

Mr. Saltzman. Well, it could possibly also be an intentional disregard of a rule or regulation. If there was a law on the books that had not yet been changed by technical corrections legislation and as long as it had not been passed, that would be subject to penalty.

So you have the situation where, at least on the penalty structure as it exists. What we are concerned about is something that the Supreme Court said many years ago, that the penalties were not meant to punish frank differences of opinion. One can debate whether or not a position taken on the basis of legislation, expected legislation, is merely a frank difference of opinion, but the problem is that frank differences are punished now by a penalty that punishes merely for a mathematical difference in the amount of tax owed and the amount of tax computed.

There is a provision in the statute where disclosure, which does ameliorate some of the problems that exist in interpretive issues, and it is that provision of the statute that we suggest still be retained, we are not talking about scrapping the provision entirely, we would suggest that that performs a useful function of notifying the Service of a position taken on a return that is at least controversial or may be.

Mr. Shaw. Thank you.

Chairman Pickle. We received testimony from the American Bar Association, and I appreciate your testimony very much. I also appreciate the patience of Mr. Smith and Mr. Portney in presenting your testimony, but I wanted to concentrate on that while you were here. I want you also to stay at the table while these two gentlemen testify and together, then, we want to ask the entire panel any questions.

I say to the ABA, I appreciate your recommendations. I have the feeling that, as we look for the answer, this committee, the Internal Revenue Service, your group and others, we are going to find that this is no easy problem. I think we all recognize, that we may end up with something as complex or more complex than what we have today. What you recommended is going to take more than a No. 2 pencil to figure out. It is going to take some big computers and somebody has got to make just as many arbitrary decisions as before, so it is not going to be a simple matter.

Now, I am always a little bit leery of a big organization, the ABA, full of big city lawyers coming in and telling us how we ought to administer all of these laws for the taxpayers of the country. But I would say that your recommendations are positive and they are a good beginning for us. We need these types of recommendations to start analyzing, so I think it has been very helpful and I personally am appreciative of it.

I think we all have a question about whether to do away with section 6661. You in effect would do it and others would not. I think if we retained the positive aspects of disclosure, that might help that part of it.

I do not quite understand, though, how you are going to handle these two-tier systems with regard to negligence and reckless misconduct; how you arrive at 50 and 25 percent; and whether the Internal Revenue Service can make any finding about what is reckless misconduct or not. I also have questions about trying to say the IRS has to prove fraud with regard to each item, because I sure do not think you can carry that too far and we are going to have to be careful about it.

By and large, it is a very solid, substantial set of recommendations and we will be studying them and we will be talking of this with you further.

Now, if you will just keep your positions, I am going to now ask Mr. Kent Smith if he will proceed and summarize his statement. Thank you for your patience.

STATEMENT OF KENT W. SMITH, SENIOR RESEARCH FELLOW, AMERICAN BAR FOUNDATION

Mr. SMITH. Thank you, Mr. Chairman and members of the committee.

I am a senior research fellow at the American Bar Foundation. I am appearing today as an individual social scientist, and not as a representative of the American Bar Foundation, and the opinions I present are my own and not those of the foundation.

Chairman PICKLE. You are the American Bar Foundation, but what interests me is are you affiliated with the ABA?

Mr. SMITH. We are the 501(3)(c) research oriented organization affiliated with the American Bar Association. We have our own board of directors and we set basically our own research agenda, conducting research largely of an empirical nature on issues in law and its interrelationship and its effects on society, and we also do research on the legal profession.

Chairman PICKLE. Do you primarily concentrate on the area of 501(3)(c)?

Mr. **Smith.** No. That is how we are structured, and the ABA is not structured that way, so we are separate entities for that reason.

Since 1983, I have been conducting and supervising research on taxpayer compliance and how various aspects of tax administration that affect that behavior.

My comments are informed by this research, by current social science models of taxpaying behavior, and by what I think is related research on enforcement and penalty strategies and other regulatory areas.

I must emphasize that very little empirical research has been done on how tax penalties actually affect compliance, and in my written statement I spell out some of the reasons for that.

In general, I think it can be said that taxpayers seem to know so little about the specifics of penalties that it is difficult to explore in detail the effects of possible penalties on their behavior.

The evidence suggests that the primary concerns of most taxpayers are comprehending what is required of them and trying to guess the likelihood that any noncompliance that they may become involved in will be detected by the IRS.

Penalties for most taxpayers are somewhat secondary to those other considerations.

My comments are going to be focused on and around the task force report of the Tax Section, and I am going to be approaching many of the same issues from a social science point of view. I think it is significant that in many cases we come up emphasizing the same issues and the same important criteria.

I wholeheartedly agree that the primary, if not the sole, objective of civil penalties should be to foster voluntary compliance, and I also think it is very important to emphasize that the penalties are just one portion of a far more general system of activities designed to foster voluntary compliance.

In many instances, additional or more severe penalties are probably not the best or most efficient way of increasing compliance.

The first response to a perceived problem among compliance should not necessarily be to impose a penalty. One needs to identify the nature of the problem, consider what types of taxpayers or third parties are involved in the problem, try to analyze why they are not complying, and then consider what should be done to improve this type of compliance by this type of taxpayer.

At that point, and it is only at that point in the analysis, the penalty should be among the integrated set of tools considered. In evaluating and reforming the group of penalties, we need to undertake the same type of analysis of the nature of the noncompliance problems that are intended to be addressed by the penalties and how the penalties in practice are working. Relating the penalties to general principles without paying attention also to what kinds of problems are being addressed by both of them becomes very complicated.

One other thing that I should mention about the nature of penalties is penalties apart from fraud, if you think about it, generally do not apply to "prohibited actions." Noncompliance that is covered by penalties in most areas of tax generally involve the failure to do completely a prescribed set of actions. They are not really penalties for doing some proscribed action, so that one has a negative incentive to do something fully and completely, as opposed to a negative incentive to not do something, which becomes a complex situation that may mitigate the effectiveness of penalties.

In moving from general objectives of supporting voluntary compliance to specific penalties, we need to identify a limited set of criteria, just as the way the ABA task force has done.

In the first part of their report, they identify some of the criteria, but I think there are some other very important ones that are presented often implicitly in other sections of the report, and I want to pull all of those together and highlight them.

A useful starting point for doing that is to ask just how penalties might actually affect voluntary compliance. Even though we lack empirical data on the effects of penalties, identifying the processes or mechanisms by which penalties can affect compliance gives us a framework for considering more carefully how a particular penalty might affect behavior of specific types of taxpayers.

Most discussions of penalties focus solely on deterrence, but it is important to realize that that is only one process that may occur. The perceived possibility of a penalty can deter individuals from doing something through a conscious cost benefit analysis of what the consequences of that action are going to be.

For civil tax penalties, the focus is on the objective material costs and on the perceived likelihood that penalties would be imposed should someone do some action.

Chairman PICKLE. Mr. Smith, I must interrupt you. We have a vote on and we have only about 5 minutes to get there. We will have to declare a recess for approximately 10 or 15 minutes. We will return just as quickly as we can. Let me also say to you and Mr. Portney that you will need to summarize your statements. We have two other panels of considerable size that we also want to hear from. I do not want to cut anybody off, but I want to remind everybody of the time element.

We will stand in recess now for about 10 to 15 minutes.

[Short recess.]

Chairman PICKLE. The subcommittee will come to order.

Mr. Smith, if you will proceed with your testimony. Pardon this interruption.

Mr. SMITH. They are critical interruptions.

Let me just very briefly try to summarize what I think are important points that have not been raised elsewhere this morning that come out of the report.

In addition to deterrence, I think it is very important to realize that penalties can also help to reinforce and legitimate what the acceptable norms of taxpaying behavior are, that they help define what is expected of people, not just punishing them. They can also provide a prod to paying sufficient attention to taxpaying matters that people who have not thought carefully about the cost-benefits of complying, at least start paying enough attention to paying their taxes that they do not make inadvertent errors.

Now, as I argue in my written statement, I think a series of general criteria follow from those, many of which have already been discussed, but some I think need special highlighting.

In terms of fairness, there is also an element of fairness concerning equity across taxpayers, and, Mr. Chairman, I guess this goes to your point about big city lawyers, that I am particularly concerned here that the penalty structure and its goals make sense and are effective for the large number of middle and lower income taxpayers who also have to confront it and are exposed to penalties, but are among the 50 percent of them that prepare their own returns, one has to be concerned about how the penalty structure is working for them as well.

One has to try to also try to minimize the advantages vis-a-vis penalties that the sophisticated or represented taxpayer is going to have against the taxpayers who is not.

The second point is the penalty should be designed so that the correction of errors by taxpayers and third parties, without any intervention by the IRS, is always encouraged, rather than discouraged by the structure of the penalties.

From some data, I would also emphasize that penalties and the imposition of them must be visible and recognized. Data suggests that many people who have been penalized do not realize they have been penalized, and many people who have not been penalized think they have been. Without that basic visibility of penalties, they cannot have an effect on behavior.

Taxpayers also must understand why a penalty has been imposed, what they should have done to avoid the penalty, and in the case of abatements, all taxpayers should have some understanding of what they could have done in order to have received an abatement.

As the study for the SBA report that was released by the IRS yesterday on focus group discussions of penalties, a recent study by the GAO on service center correspondence all reveal, a lot of the issues involved in penalties are administrative. Fair outcomes that take into consideration the relevant circumstances and the culpability of the taxpayer, cannot be achieved by highly detailed statutory language alone, nor can they be achieved only by going by the book of lengthy revenue manuals.

The system has to be designed to allow for some reasonable amount of discretion, but that discretion must be carefully controlled, supervised, and evaluated or it will introduce its own unfairness to the system. With any enforcement activity, as was pointed out, there is going to be discretion. Unreasonable penalties are not going to be enforced somewhere along the line, and one has to take that into account in designing penalties.

An observation about the coordination of penalties and the pyramiding that has been talked about. Legislation coordinating and specifying the circumstances under which penalties will not pyramid on top of each other may go a long ways toward that, but there will always be situations in which multiple penalties end up being imposed upon an unusual circumstance that cannot be covered by legislation.

There are situations now in which everyone agrees the sum total of penalties is excessive and unfair, but the situations are so disparate and relatively unusual that they cannot be covered legislatively or statutorily or by revenue manuals.

I would suggest that it may be appropriate to introduce some notion of excessive total burden as an additional——

Chairman **Pickle**. Excessive what?

Mr. **Smith**. Excessive total burden on the taxpayer of the sum total of all of the penalties that have been imposed upon the taxpayer in a particular situation, that beyond some threshold, that that become an additional criterion for abatement, in addition to reasonable cause Such an approach might provide a safety valve to those egregious situations that everybody agrees are egregious but, taken penalty by penalty, there is no reasonable cause basis for abatement and there is nothing that one can do about the sum total of penalties. No matter how legislation is written, I think there will always be the possibility of such situations and some procedure needs to be provided.

A final concluding comment about the process by which reform of penalties needs to proceed. It may almost be a cliche that there is a need for more coordination between tax policy and legislation on the one hand and tax administration on the other. I think it is particularly important in the case of penalties.

Penalties are not basically tax policy, they are ultimately an administrative tool to be used as part of an overall program to foster voluntary compliance. If a penalty is going to be very difficult or inefficient to administer, if it is going to have negative impacts on other aspects of compliance that overwhelm the positive impact it may have on a particular aspect of noncompliance, then it should not be added to the arsenal or should be taken out of the arsenal or modified. To get that perspective, therefore, I think it is very important that IRS officials, with an understanding of the realities of actually enforcing penalties out there in the field and in service centers, be involved in the process of considering penalty reform. And tax practitioners and other representatives of the taxpayers against whom penalties are now being imposed, both by design and by accident, also have to be involved in the process, so that there is some consideration about how our penalties are actually working in terms of compliance.

I commend the committee for taking the approach they have taken so far of cooperation with the IRS, with the tax practitioner community, with the SBA, with the other representatives who are here. I think you are taking the right approach and I commend you.

Thank you.

[The statement of Mr. Smith follows:]

KENT W. SMITH
SENIOR RESEARCH FELLOW
AMERICAN BAR FOUNDATION

Mr. Chairman and Members of the Committee:

I. Introduction

I am Kent W. Smith, Chicago, Illinois, a Senior Research Fellow at the American Bar Foundation. I am appearing here today as an individual social scientist with experience in research on tax compliance. The views I present are my own and not those of the American Bar Foundation, its officers and directors, or others associated with the Foundation's work. From 1983 to 1987 I was director of the Taxpayer Compliance Research Project at the American Bar Foundation. Our research was closely coordinated with the work of the ABA Commission on Taxpayer Compliance. My major areas of research continue to be taxpaying and tax administration.

The primary focus of my comments is the report of the Special Task Force on Civil Penalties of the ABA Section of Taxation. I am addressing the issue of civil penalties from the point of view of a social scientist rather than from that of a tax practitioner or administrator. In our research we have conducted extensive interviews with tax practitioners and IRS employees, and we have analyzed a wide range of data on taxpayers and tax practitioners, including data and statistical compilations available from the IRS. My comments will be informed by this research, by current social science models of taxpaying behavior and decisions, and by the analytically related research on enforcement and penalty strategies in other regulatory areas. I must emphasize, however, that very little empirical research has been done specifically on how penalties affect compliance.

There are several reasons for this relative lack of research on civil tax penalties, many of which involve problems of inadequate data. The proportion of taxpayers with direct experience with penalties related to the underpayment of income taxes is relatively small, and it consequently is difficult to obtain an adequate statistical sample of penalized taxpayers from general populations of taxpayers. The IRS can more readily identify samples of relevant taxpayers, but the administrative data they have on penalties and the subsequent behavior of taxpayers lack the detail and consistency needed to answer many of the key questions about how penalties affect taxpayer compliance. Further, the growth in penalties has been recent enough that it is still too early to trace the long term effects of penalties. Unpenalized taxpayers who may be noncompliant or are contemplating noncompliance generally know so little about the specifics of penalties that it is difficult to explore in any detail the effect of possible penalties on their behavior. The primary concern of most taxpayers, at least as revealed in surveys and interviews, is the likelihood that noncompliance will be detected by the IRS.

II. The Primary Objective of Civil Penalties

The current hodge podge of over 150 civil penalties developed because individual problems of noncompliance have often been addressed piecemeal by new penalties. Trying to fix one problem with a penalty without sufficient attention to either administrability or the effect of the penalty on other aspects of the taxpaying system has often led to unexpected and unwanted consequences. The current movement to reform the set of civil penalties must avoid the same ad hoc process of addressing problems of individual penalties without some overall guiding set of principles and a design plan for the system of penalties as a whole. The Task Force, therefore, appropriately begins with a consideration of the overall objective and purpose of civil penalties and a limited number of criteria that should be met by penalties individually and collectively if they are to achieve that overall objective.

The Task Force cogently argues that the primary objective of civil penalties should be to foster voluntary compliance with tax laws and regulations.[1] This objective is also the one identified by Charles Hall, chair of the ABA Section of Taxation, in his testimony before this subcommittee on March 31, 1988, and by the Executive Task Force for the Commissioner's Penalty Study in their draft of a philosophy of civil tax penalties distributed for comment in June.

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[1] Following the ABA Commission on Taxpayer Compliance, I am using the term "voluntary compliance" broadly to mean the timely and accurate reporting of necessary information, filing of returns, and paying of taxes owed without enforcement intervention by the tax administration.

I agree completely with this overall objective of civil penalties. The Task Force also cites legal precedents for viewing penalties as a means to reimburse the government for the costs of investigating and discovering noncompliance. I have serious reservations about using this as even a secondary objective for civil penalties. To be a convincing justification for penalties, the income from penalties would have to be allocated to enforcement activities, and there are innumerable and severe hazards to developing an enforcement system that in any way is intended to pay for itself directly through income from penalties and fines. Moreover, the Task Force identifies far more appropriate criteria for determining the size of penalties that are not necessarily correlated with any reasonable allocation of the cost of enforcement across various interrelated types of penalties. As I shall discuss later, penalties should be seen as fair and reasonable by the majority of taxpayers; and taxpayers in general would almost certainly not use indemnification of the government for enforcement expenses as a basis for judging the fairness of a penalty.

I also agree that it is important to view penalties as just one portion of a far more general system of activities designed to foster voluntary compliance. In many instances, additional or more severe penalties are probably not the best or most efficient way of increasing compliance. Short of fraud involving specific positive actions taken to underpay taxes, tax compliance is generally more complex and difficult to do than is noncompliance. Tax laws *prescribe* a complex set of tasks that are both burdensome and counter to the taxpayer's immediate self interest. Penalties are imposed when taxpayers *fail* to perform these tasks. Many other laws backed by penalties are *proscriptive* ones, and penalties are imposed when individuals actively do something they are not supposed to do. My intuitive judgment, which I am told is backed by at least some psychological research, is that the threat of punishment is a better incentive to avoid doing some action than it is a prod to continue doing some positive action. "If you do that, I'll punish you" is more effective that is "I'll punish you if you don't work hard all semester and get good grades." Tax compliance generally is much more like the latter than the former.

Penalties are a special aspect of an overall compliance program in another way as well. They are like military forces intended to guard the peace. The continuing possibility of their use is necessary, but one hopes they never have to be used. We therefore cannot use the frequency with which penalties are imposed as an indicator of their effectiveness in meeting their overall objective. Indeed, every instance of a penalty that is actually imposed in an instance in which the overall goal of voluntary compliance has failed. As Charles Hall put it in his March statement, "Increased revenues from penalties probably indicates the existence of other problems in the voluntary compliance system and would not be good news."

Having established the primary objective of penalties as fostering voluntary compliance, the next step in developing an overall plan for reforming penalties is to identify a limited set of criteria that can be used in designing specific penalties and evaluating whether or not they are consistent with the primary objective. In the first part of their report, the Task Force identifies some of these criteria, but there are other very important ones presented, often implicitly, in other sections of their report. Some that I think are relevant for all penalties are presented in the context of specific penalties. In the rest of my comments, I want to identify a set of major criteria and outline one rationale for how they are empirically and logically related to the primary objective of fostering voluntary compliance.

III. How Penalties Foster Voluntary Compliance

A useful starting point for developing more specific criteria is to ask how penalties can actually affect voluntary compliance. Even though we lack empirical data on the effects of penalties, identifying the mechanisms or processes by which penalties can affect compliance gives us a framework for considering more carefully how a particular penalty or change in a penalty may affect the behavior of specific types of taxpayers. Most discussions of penalties, including the report of the Task Force, focus solely on deterrence; but there are at least two other ways penalties can affect compliance: they can also help reinforce and validate norms of compliance and they can serve as prods to increased diligence in tax matters. All three processes can be both *specific* and *general*, specific in the sense that they affect the future compliance of the particular taxpayer against whom a penalty has been imposed and general in the sense that they affect the compliance of other taxpayers who are not themselves penalized.

Deterrence. The perceived possibility of a penalty can deter individuals from doing something through a rational--or irrational--cost-benefit analysis. For monetary penalties, the focus is on objective, material costs and on the perceived likelihood that they will be imposed should one engage in some action or, as is more often the case in taxpaying, fail to perform some action.

To maximize deterrence, the focus is on some combination of severity, certainty, and swiftness. Most research on deterrence has found that certainty is by and large more important than severity: individuals in many cases do not use an objective calculus of expectations.

Specific deterrence occurs if the imposition of a penalty for one act of noncompliance deters the particular taxpayer from the same type of noncompliance or some other type of noncompliance in the future in order to avoid another penalty. Specific deterrence requires that the penalized taxpayer (1) knows that a penalty has been imposed and (2) has a reasonably accurate understanding of what is required to avoid another penalty.

General deterrence, of course, is when the imposition of a penalty on one taxpayer deters other taxpayers from noncompliance in order to avoid a penalty. General deterrence requires that other taxpayers (1) know that penalties are imposed and (2) have a reasonably accurate understanding of what is required to be in compliance.

Norm Validation. Cultural anthropologists have emphasized that one function of deviancy and the punishment of it by authorities and other members of the society is to help define the limits of acceptable and appropriate behavior. If the penalties for noncompliance are seen as legitimate and just, they can validate and reinforce the norms of compliance and cooperation with the tax system. The focus here is primarily on fairness and consistency to the extent that consistency refers to the fact that penalties are not given to those were compliant or otherwise not deserving of a penalty. To quote from an earlier draft of the IRS statement of a philosophy of civil tax penalties, "Compliant taxpayers should be assured that compliant behavior has moral value, and this assurance can be achieved through penalizing noncompliant behavior. Noncompliant taxpayers as well should be shown that society values compliant behavior, and this can in part be achieve by penalizing noncompliant behavior."

Specific validation is not very often discussed, but it clearly does occur. Penalizing someone for noncompliance can reinforce for the person the feeling that the noncompliance was wrong and either change the person's normative view or increase the salience of normative factors versus other factors affecting the person's behavior. Specific validation requires that the penalty itself is fair and that the procedure by which it was enforced is perceived to have been fair.

General validation is when penalizing the noncompliant reinforces and validates the compliance norms of others, both those who were compliant and those who may not have been compliant but have not yet been detected or sanctioned.

Prod to Diligence. There is a third mechanism that does not clearly fit into either deterrence or norm validation. Noncompliance often occurs out of mere "sloth" or lack of due diligence. The possibility of a penalty occurring if one does not due things carefully and expeditiously can be an added prod to "do things right the first time." Deterrence generally assumes that the person has *actively* considered the relative costs and benefits; penalties can also be a prod to get those who do not think much at all about compliance or noncompliance into thinking enough about the process of filing and paying that they will make an effort to avoid errors. Taxpayers differ considerably in the degree to which taxpaying is an area of active decision making and effort. For penalties to be prods to diligence, there must be a balance between fairness and reasonableness on the one hand and severity on the other. One does not want a penalty system that prods individuals so strongly and overbearingly that they become actively aware of the tax system and of how much they dislike it.

A particular penalty can affect taxpayers through all three mechanisms, and the possibility of all three mechanisms must be considered in designing penalties. The goal should be that the sum total effect of the penalty on all of the relevant taxpayers through all three mechanisms is positive vis à vis compliance.

IV. Criteria for Penalties

In light of these possible ways that penalties can affect voluntary compliance, I suggest that there are five major criteria that penalties individually and collectively should meet. They should be

A. Fair and just in terms of being (a) appropriate and commensurate with the seriousness of the noncompliance, (b) equitable across taxpayers, and (c) equitable across offenses;

B. Designed so that the self-correction of errors is encouraged rather than discouraged in terms of expected penalties;

C. Visible and known both to taxpayers in general and to those against whom they are imposed;

D. Understood especially with respect to the actions that are likely to incur a penalty and with respect to what must be done to avoid a penalty; and

E. Simply structured and coherent.

A. Fair and Just Penalties

All of us would agree that penalties should be fair. But "fair" means many different things to different people, and we must specify more precisely what we mean by fair if it is to be a useful criteria for evaluating penalties. Fair and just are normative concepts, and the basis for evaluating them should ultimately be the societal norms concerning what is appropriate behavior and appropriate mechanisms for punishing inappropriate behavior. In terms of tax noncompliance, I would emphasize three aspects of fairness and justice for penalties.

Appropriate and Commensurate with the Seriousness of the Noncompliance. The fairness of penalties and other punishments is judged relative to the perceived seriousness of an offense. A fair penalty is one that is commensurate with seriousness. Below a certain point the penalty is considered too lenient relative to the offense; above another point it is considered too severe. But what criteria do people use for seriousness? The Task Force suggests that seriousness should be measured against "the threat to the tax system created by the conduct involved." I have two reservations about using this yardstick. First, I do not know how one would estimate the threat to the tax system. The phrase seems to imply more than merely the size of the underpayment. Are we talking about the threat of an isolated instance, the threat should the type of noncompliance go unchecked and become widespread, the threat including the cost of opportunities lost because of the effort needed to detect and correct the noncompliance, or what? Second, and more importantly, I do not think this is the yardstick typically used by individuals in evaluating the appropriateness of penalties; and using it is likely to lead to penalties that are widely considered to be either unjustly harsh or unjustly lenient. Indeed, two other more typical yardsticks are implicitly used elsewhere in the report: the culpability of the taxpayer and the size of the tax underpayment.

Culpability. The culpability of a taxpayer in a particular situation is itself a difficult quality to measure with any consensus or consistency, but the Task Force's recommendations concerning three levels of taxpayer penalties provide a useful starting point for developing indicators of culpability. Underlying the hierarchy of negligence, intentional disregard of the law, and intentional commitment of fraudulent acts designed to conceal noncompliance is a continuum of culpability.

In common law, culpable negligence is often measured against the criterion of what an individual of common prudence *and equal experience would normally do under the same circumstances*. Equal experience suggests that determinations of negligence should take into account both the general ability of the taxpayer to understand and perform the necessary tasks and the taxpayer's more specific experience with similar tax situations in the past. Our interviews with tax examiners suggest that such factors are in fact being used in the field. The self-employed painter with a high school education is not held to the same standard as the small business person with an M.B.A. Similarly, more is expected of individuals who have been dealing with the same situation for years than is expected of those confronting an issue for the first time. Unfortunately, the administrative information that is currently recorded and retained by the IRS does not permit an adequate independent check on the past experience of the taxpayer.

The emphasis on the circumstances of the instance of noncompliance underscores the fact that all of the relevant considerations cannot be written into legislation or even into operational manuals. There must be room for carefully managed and evaluated discretion in the field, a point to which I shall return later. The fact that appropriateness is evaluated relative to the tax situation of the individual also suggests that perceptions of fairness concern the total penalties imposed for a particular tax situation; fairness is not evaluated penalty by penalty in instances in which multiple penalties are imposed. This is in large part why the pyramiding of penalties is so widely viewed as an unfair aspect of the current set of penalties.

Another element in the Task Force's continuum of culpability is intentionality. In large part, it is probably operationally evaluated along the same dimensions as is negligence: the past experience of the taxpayers, their presumed knowledge and understanding of the tax requirements and the consequences of noncompliance, the reasonableness of their efforts to obtain accurate information and advice, and their involvement in and understanding of their own financial arrangements. Again, these dimensions have as much relevance for the administration of penalties as they do for the crafting of legislation.

Size of the Underpayment. The other criterion underlying many of the Task Force's recommendations about the size of penalties is that they should be commensurate with the size of the underpayment resulting from the instance of noncompliance. This is a far more readily determined criterion than is the threat to the tax system created by the noncompliance, and I think it is consonant with most taxpayers' evaluations of the appropriateness of penalties. This may seem like an obvious criterion for the size of penalties, but some important desiderata follow from it that would go a long way toward improving the perceived fairness of penalties. These are mentioned at various points in the report, but I think they should be highlighted as an interrelated set that follow directly from the criterion that the size of penalties should be pegged to the size of the underpayment.

1. Penalties should not be based on the total tax liability or underpayment. They should be either based on the amount of underpayment due to the culpable noncompliance or a flat amount.
2. Penalties should be structured to avoid what are variously referred to as "notches," "cliffs," or "slippery slopes." A slight increment in the size of the noncompliance should not result in a large stepwise increase in the size of the penalty.
3. The other side of the second point is that the size of a penalty should not be level as the size or seriousness of the offense increases. This point is related to the second general criteria for penalties, that they should always encourage self-correction of errors; and I shall return to it after a few comments on the other two aspects of fairness.

Equity across Taxpayers. Another key aspect of the fairness of penalties is that similarly situated taxpayers should be treated similarly in terms of the penalties they receive. Improving the appropriateness of penalties with respect to the seriousness of the offense will do a great deal to achieve this aspect of fairness. But equity across taxpayers raises some other points as well. Taxpayers with extensive experience with IRS enforcement activites and those with experienced professional counsel and advice will always have an advantage, but one goal of both legislation and administrative procedures should be to minimize the size of that advantage. Special attention therefore should be paid to minimizing differential outcomes in those situations in which the taxpayer must take the initiative or in which the burden of proof is given to the taxpayer. In these situations the options that are available to taxpayers should be clearly and routinely explained by tax administrators, and as much guidance as possible should be given concerning the type of evidence or information they must give to make a convincing case. For instance, simply requiring individuals to state in writing their case for reasonable cause in abating a penalty is most likely going to introduce more inequity across taxpayers than is a form or questionnaire asking for the specific types of information that are in fact used by examiners in determining reasonable cause.

Equity across Offenses. Equity of penalties across offenses has received less attention than has equity across taxpayers, but it also is an important aspect of fairness. Are equally serious offenses involving equal levels of culpability being equally treated in terms of enforcement and penalties? There currently is clearly not equity across offenses, and achieving it will require a great deal of statutory and administrative work. Is it equitable that leaving $50 of IRP-covered income off a return receives a presumptive negligence penalty while leaving $50 of income that is clearly shown in a check book or overstating membership dues by $50, when discovered in an examination, generally avoids any penalty at all?

B. Encouraging Self-Correction of Errors

A second general criteria for a coherent system of penalties is mentioned toward the end of the report of the Task Force, in their discussion of penalties related to information reporting. "Penalty rates (and abatement policy) should be structured in such a manner than it is always in the taxpayer's interest to correct erroneous information." Given the cost and burden of correcting errors and, in many instances, the relatively low probability that an error will ultimately be detected by the IRS, penalties should be structured so that they are at a minimum when taxpayers or third parties report and correct their own errors while they are still relevant for tax administrative purposes. Of course, this criterion needs to be tempered still with culpability. If a taxpayer every year corrects the same error or turns in the required information just a bit after the deadline, questions of culpability should be raised in weighing the size of the penalty. Again, such evaluation of the experience of individual taxpayers requires more detailed administrative data about penalties than is currently possible.

C. Visible Penalties

All three of the mechanisms by which penalties may affect compliance both specifically and generally rest on the fact that penalties are visible. Taxpayers must know when a penalty has been imposed on them if it is to have any effect on their future behavior. Similarly, taxpayers in general must have some knowledge of the existence of penalties and of the fact that noncompliance is subject to correction and penalty should it be detected. This again is an obvious point, but surveys and interviews with taxpayers indicate that they are frequently unaware of the fact that they have been penalized. Just a troublesome, some believe they have been penalized when in fact they have not been. The importance of visibility is not emphasized in the report of the Task Force because most of their examples involve either corporations or wealthy individuals. We should not lose sight of the fact that penalties also must be designed for the typical middle and lower income individual taxpayer, especially the approximately fifty percent of them that continue to prepare their own returns.

D. Understandable Penalties

Taxpayers must also understand *why a* penalty has been imposed upon them and what they should have done in order to have avoided the penalty. At the abatement stage, taxpayers should understand why their penalty was or was not abated and what changes in circumstances would have resulted in an abatement. Unless this criterion is met, being penalized in the past does not provide a clear indication of culpability for repeat offenses. General effects of penalties on compliance likewise presupposes that other taxpayers understand what actions or nonactions are subject to penalties.

Another very important reason for making the types of actions that are subject to penalties widely known and understood is that the goal should be to encourage the voluntary payment of the *proper* amount of tax, not the proper amount plus a cushion to avoid possible trouble with the IRS. Many taxpayers now are not taking all of the deductions they should because they want to make certain they will not be penalized for noncompliance.

As the Task Force points out, specifying clear and understandable conditions for a penalty suggests that penalties are most appropriate for setting minimum standards of compliance. They are probably inappropriate in those gray or ambiguous areas in which there is likely to be considerable disagreement among reasonable individuals about what constitutes adequate compliance.

The Task Force at various points also argues that the size of the penalty should be both clearly understood and predictable to those contemplating noncompliance. I think this aspect of comprehensibility is less important. Some models of decision-making under uncertainty, in fact, suggest that taxpayers would be more risk adverse if the size of the penalty were somewhat uncertain. Making the size of the penalty totally predictable will encourage tight "arbitraging" and careful cost-benefit analysis of compliance decisions. If anything, we want to move toward defining compliance more in normative than in game-playing terms. There may be good arguments for not including interest calculations in the determination of penalties, but I do not necessarily believe this is one of them.

E. Simplicity

Finally, the other four criteria for a good system of penalties designed to foster voluntary compliance will be much easier to achieve if the structuring of the penalties is as simple as possible. For example, developing a series of taxpayer penalties arranged along a continuum of seriousness is obfuscated if the sizes of the penalties are calculated on entirely different bases rather than simply at different rates or amounts.[2] A complex and uncoordinated system is also more likely to be seen as excessive and unreasonable, capricious and out of control.

In the current discussion of penalty reform, most of the emphasis on simplicity has been from the point of view of the taxpayer and tax practitioner. Simplicity is just as important or more important from the point of view of the tax administrator. The typical taxpayer needs to be concerned about a limited number of possible penalties. The IRS, on the other hand, must be concerned with all 150 of them and is confronted with the impossible task of trying to develop an administrative system in which they will be all fairly and equitable administered in keeping with legislative intent. An administrable system of penalties must be a simple one.

Simplicity in many ways should be a goal in an of itself. Perhaps we should adopt the Occam's Razor of civil penalties. A basic principle in philosophy, known as Occam's Razor, is that if two theories will explain the same set of facts, then the simpler theory should be accepted. Correspondingly, Occam's Razor of penalties would be that if two systems of penalties will achieve the same goal of fostering voluntary compliance, then the simpler one should be adopted.

V. Coordination of Penalties and the Problem of Pyramiding

Another theme in the report of the Task Force and in several other discussions of current problems with penalties is the fact that several penalties often pile on top of each other for the same instance of noncompliance. I would like to add a few additional observations.

First, multiple penalties that may apply to the same basic type of noncompliance but which reflect different levels of culpability and underpayment should in general not be imposed together. Determine the level of culpability and underpayment and impose the one most appropriate penalty.

My second observation returns to the fact that appropriateness is generally evaluated relative to the tax situation as a whole, not penalty by penalty. The general problem of coordination of penalties of different types requires the development of a set of typical tax situations in which they may be imposed. If it turns out that two or more penalties are frequently applied to a common tax situation, then legislative guidance needs to be provided on how they should be coordinated. In many cases, coordination may involve specifying that certain penalties should not be applied in clearly specified sets of circumstances when another specific penalty is also applied. Such an approach has worked well in the past, but it runs the danger of added complexity. It probably only works if the tax situation involving the same set of multiple penalties both occurs frequently and is clearly specifiable. If it turns out that some penalties are almost always given together and rarely separately, then they should be legislatively combined and simplified.

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[2] On the other hand, standards and burdens of proof probably should vary with severity.

However, such legislative coordination cannot hope to cover all situations in which multiple penalties are applied. There are situations now in which every one agrees the sum total of penalties is excessive and unfair. The situations, though, are so disparate and relatively unusual that they cannot all be covered legislatively. I would suggest that it may be appropriate to introduce excessive total burden as an additional criteria for abatement that would only apply to instances of multiple penalties. Such an approach would provide a safety valve for those egregious situations that are currently beyond the authority of the IRS to correct. Should such an additional criterion of excessive burden be introduced, systems should also be developed so that abatement proceedings are automatic in extreme cases; otherwise new inequities between taxpayers may arise.

VI. Concluding Observations

In closing, I would like to offer two more general observations about reforming the system of civil penalties.

First, determining the proper level of a penalty for a particular situation will never be exact. There will always be some "false positives" (innocent people being penalized) and "false negatives" (guilty ones going unpenalized). Should the system of penalties and their administration be tilted toward one or the other? Is it better to miss or underpenalize a deserving noncompliant person occasionally than to penalize a compliant person occasionally? I think an argument can be made that the tilt should generally be toward minimizing false positives. Part of my reason for believing so comes from the research by Katz and others on bureaucratic encounters, in which they found that negative experiences had more effect on people's attitudes toward the bureaucracy than did positive ones. This same "ratchet effect" shows up in the excessively negative responses to media stories about the IRS's incorrectly penalizing compliant taxpayers.

Second, it is perhaps commonplace by now to argue that there should be more coordination between tax policy and legislation on the one hand and tax administration on the other. However, such coordination is particularly crucial in the case of penalties. Penalties are ultimately an administrative tool to be used as part of an overall program to foster voluntary compliance. If a new penalty is going to be very difficult or inefficient to administer or if its negative effects on other aspects of compliance are likely to be greater than its positive effects on a particular problem of noncompliance, then it should not be added to the arsenal. IRS officials with an understanding of the realities of enforcement out in the field and in service centers and tax practitioners who work with the types of taxpayers against whom the penalties are likely to be imposed, either by design or accident, both need to be involved in the process of penalty reform. Mr. Chairman and Members of the Committee, I commend you for the focus of today's hearings, and I encourage you to continue the cooperative process through which you are approaching penalty reform.

Chairman Pickle. Thank you, Mr. Smith. Before I go to Mr. Portney, I notice you make a provision here when you talk about norm validation, that you said that cultural anthropologists have emphasized that one function would be to define the limits of acceptable behavior. Can you identify who you visited with? [Laughter.]

Mr. Smith. From Boas and Malinofsky and Emile Dirkheim and back for probably the hundred years of cultural anthropology, I think that has been a running theme that every society has a certain amount of deviance, and part of what that deviancy can do if it is punished by the authorities is that the acts and their punishment help define what society considers to be appropriate behavior.

Chairman Pickle. But in many respects we are tax animals being analyzed. I suppose that is right.

Now, Mr. Portney, would you proceed with your statement?

STATEMENT OF GERALD G. PORTNEY, ESQ., PEAT MARWICK MAIN & CO., WASHINGTON, DC

Mr. Portney. Thank you, Mr. Chairman.

The written statement which I have submitted previously and any other comments that I make this morning are really mine, based upon 26 years in the Internal Revenue Service and the last 5 years in private practice, dealing with a broad spectrum of taxpayers and third-party information providers.

I would like to begin by emphasizing an area that I think needs a great deal of emphasis and undoubtedly will be addressed by subsequent witnesses today, and that is information reporting.

I believe, and I think many others, that the linchpins of our tax system's reporting and revenue collection process are the withholding and information reporting system. I think the system depends very greatly on both of those.

And while the information reporting system rests and relies so heavily on third parties to record properly, to file and to furnish information, the incentives to do so, in my judgment, Mr. Chairman, are negative, and they are presented in the form of a very significant share of those 150 penalties that you have previously alluded to.

I think ultimately there is a need for a serious effort to pursue the notion of positive incentives for compliance. I think it probably applies to the whole tax system, but it certainly ought to apply with a body of people who have been drafted by the Government as surrogates to enhance and encourage and enforce compliance for the Internal Revenue Service, and certainly at no fee.

Now, while I think the overall task of pursuing positive compliance ought to be undertaken, it is not likely to produce any short-term solutions, but I think there are some steps in the short term that can be taken and that will have a positive effect on both taxpayer attitudes and revenue collections, two objectives that I think are very worthy.

First, it seems to me that there ought to be a policy supported by the appropriate legislative and administrative rules that clearly encourages self-correction of errors which are discovered by taxpayers or third-party information providers and corrected in time for the information to be used.

In my judgment, there should be no threat of penalty under those circumstances if the taxpayer has had no previous history of noncompliance. I think that is fairness.

Second, where the Service discovers the error first, again absent previous history of noncompliance, I think that the notion of a first-time offender should be employed to produce a written notification to that taxpayers or payor, reviewing the requirements that are in the rules and regulations, and also indicating that repetitive acts will be subject to penalties which are then clearly described. I think that is an example of fairness.

I think, third, the system ought to be based on the notion of progressive punishment, and that system is required for those whose demonstrated indifference, disregard or worse, results in repetitive acts of noncompliance which are duly punished. I do not think we have that today.

To use the vernacular, if I may, in the generic way, I really think that it is incumbent on everybody who has a role in the system, the Congress and the Treasury and the Service, to draw brighter lines than we have today between the good guys and the bad guys. It is really hard to distinguish in terms of the way the penalties are structured and the way they are administered.

I also think that by doing that, adversarial tensions would be reduced and who knows what impact might result by newly created goodwill that that might engender.

People say there is no way to judge what a taxpayer's previous history of compliance or penalty determination has been. Well, it seems to me that that cannot be a very big problem. Most States, as far as I know, have records in their motor vehicle administrations that record adjudicated motor vehicle violations against licensed drivers, and there is a system of sanctions or steps that are taken at various levels up to and including suspension of the right to drive. Now, it seems to me analogous measures could be adopted in the tax system which result at the margin in a combination of both significant dollar penalties plus guaranteed audits.

What I think the system needs, Mr. Chairman, is the carrot to go along with the stick, and I recommend that information reporting be at the vanguard of this aspect of penalty reform.

With regard to taxpayer penalties, which my colleagues on this panel have dealt with, I really do think that there is both a superb opportunity and a compelling need to bring about true simplification and fairness with the most important of the taxpayer penalties. And I really do believe that it is doable.

The first thing we ought to do is eliminate this notion of presumptive guilt. It is really offensive to American jurisprudence, and I don't know why it has become so entrenched in the tax law.

To begin with, it reinforces public perception, that when it comes to the IRS, the taxpayer is guilty. I think the presumption is wrong. I don't think the IRS looks at it that way, but that is the perception out there. And this presumptive guilt notion really does reinforce it.

I also think it's fair to say that the nearly 1 million individual taxpayers—these are not corporations, these are not big institutions, these are individual taxpayers who were assessed negligence penalties in fiscal 1987, this last fiscal year, did not begin to understand, nor is it reasonable for them to understand the legal standard of clear and convincing evidence. Because that in fact is the standard that they would have to meet to overcome the presumed negligence penalty, which is presumed to the point that it reflects itself on an IRS Service Center bill, which says to the taxpayer you owe this money, not we think you might, but you owe this money.

I think the penalties—and I agree with my colleagues—for fraud and negligence ought to be set at stand alone rates that are high enough to make a difference without the presumption of guilt, without the shifting of burdens, and without the interest based additions.

I do disagree with my colleagues about the fraud penalty in one sense. At 75 percent it is a bargain. There is precedent outside the tax law for treble damages. We see it every place else. And it seems to me, in the case of fraud, where the underpayment of tax due to fraud has been established by the Internal Revenue Service, that ought to be multiplied by three. Fraud is the most reprehensible behavior and should be singled out accordingly.

I think this is also consistent with the point that I am trying to make, that there ought to be brighter lines, clear distinctions between those who are making a real effort to do it right, fall short, because they are not perfect, or because they don't happen to have highly experienced and highly competent representatives, on the one hand, from those who are engaging in conduct which is the most egregious on the other.

The penalty for substantial understatement I think is seriously flawed. I think it is flawed from a policy standpoint, and from a legislative standpoint and those flaws have been addressed by other witnesses. But I also think it is flawed from an administrative standpoint.

When that provision was enacted in 1982, the conference report was a typically well-drafted, well-articulated document. And there is a sentence in there that has been overlooked too often in the administration of this penalty. And that sentence simply says, and I'm paraphrasing, but I think this is pretty close, that it is the intent of the Congress that this penalty for substantial understatement be asserted only against those who take highly aggressive filing positions and not to those who, in good faith, endeavor to reply. And I think the evidence is quite clear, that the penalty has become a pure mathematical based penalty. And I don't think that's what Congress intended, but that's what's happening in real life.

Finally, Congress should eliminate the instances of pyramiding and overlap, and also the very difficult to understand and administer standard of due diligence in the information reporting area.

Due diligence is like clear and convincing evidence. It is wonderful for lawyers to sit around and debate about. But it is simply unrealistic in terms of translating to lay people, taxpayers and others who have to deal with this on a day-to-day basis. I think the information reporting area has demonstrated beyond a reasonable doubt the failure of due diligence as a concept to administer.

What the Service draft and the ABA task force report have accomplished I think is laudatory. It does provide both a philosophical framework and a sufficiently detailed road map to make a significant step on the journey to both fairness and simplification. The efforts of this committee, the Internal Revenue Service, and the bar, are to be commended and what has been developed so far will have very wide support.

Thank you very much, Mr. Chairman.

[The statement of Mr. Portney follows:]

Statement of Gerald G. Portney

Mr. Chairman and Members of the Committee:

My name is Gerald G. Portney and I am a principal in the accounting firm of Peat Marwick Main & Co. I am here today at the request of the Committee, solely in my personal capacity and as a former careerist in the Internal Revenue Service for more than 26 years, which included the positions of District Director (1974-1979); Assistant Commissioner (Technical) (1979-1982); and Assistant Chief Counsel (Technical) (1982-1983).

Mr. Chairman, you and this Committee, along with others in both the public and private sectors, are to be commended for the interest and attention being shown to the problems of the civil penalty provisions, both structural and administrative in nature.

"If we had to pick a topic that single-handedly deserved the credit for raising the adversarial tension in the tax system, I submit that penalties would win more votes than any other subject." Commissioner Gibbs.

...I appreciate your invitation to testify on the penalty system.

There are presently two important papers which have been prepared and made available on the subject of civil tax penalties: one is a discussion draft (6/8/88) prepared by an IRS task force, entitled "A Philosophy of Civil Tax Penalties" (Service Draft). The other is a report (Bar Report) prepared by the Committees on Administrative Practice and Civil and Criminal Penalties of the American Bar Association's Section of Taxation.

The Service Draft is a thoughtful, balanced discussion that reflects well on that organization.

The approach of the Bar Report is very different. Though also thoughtful and balanced, it is not only limited to civil penalties but also to specific penalties on taxpayers and to third party and bad conduct situations. It also addresses information reporting penalties in a limited way. It does effectively set forth guiding principles against which their proposals may be evaluated.

The Service Draft recognizes both the realities and varieties of reasons for noncompliance and, more importantly, that penalties are not necessarily an automatic response to all instances of noncompliance. The Bar Report outlines five major consequences of the present system and specific remedies.

The principal distinction between the two papers is that one is philosophical and the other is largely technically oriented. In the final analysis, the two papers compliment one another far more than they differ.

When thoughtful people in both government and the private sector can independently examine an area of importance and find they share fundamental views on principles and more, we have the recipe for making important change with minimal controversy.

Information Return Penalties

One of the most important contributors to tax compliance is information reporting. The (I)nformation (R)eporting (S)ystem is a co-equal partner with withholding in providing the structure for income tax compliance and much of its success.

Wage and information items flowing into the IRS at approaching one billion items a year are impressive evidence of the critical importance of the role of payors. The fact that approximately 90 percent of the income covered by information reporting is voluntarily reported is testimony to both the success of information reporting and also to the opportunity to improve upon that level of compliance.

Given the virtual (if not complete) absence of positive incentives to comply, given the substantial financial burden imposed upon payors for recordkeeping and reporting, the system is fortunate, indeed. But that in no way suggests the system is working as it should.

I, along with others currently conducting a comprehensive study of the penalty system, received earlier this month a letter from a regional bank holding company on information reporting and penalties. The three pages of single-spaced type provide one of the most insightful analyses of impact of just a few of the information reporting penalty provisions upon payors of interest and dividends.

What I found particularly disturbing was this statement--

> "A review of the penalty provisions of the Code will reveal that, if you count every penalty which may be applied to every form which a financial institution files, there are over 100 opportunities for an institution to err in the information reporting area."

The 1975 study of penalties by the Administrative Conference of the U.S. is increasingly quoted for its characterization of the then number of penalties (64) as "mind-numbing." Today's count of 150 or so must be mind-shattering. Information reporting is a major contributor to the penalty explosion of the 1980's.

There are at least three premises that we should all be able to proceed from:

1. The U.S. Tax Code is complex;
2. Many taxpayers, third party recordkeepers/providers of information, and those who aid, assist and advise in connection with the preparation of tax returns of others try to play by the rules; and
3. There are too many penalties in the Code.

If the objective is to collect the proper amount of tax from those who have an obligation under the rules to pay, we need to do more than reduce the number of penalties.

We need to get the message out through legislation and through tax administration that the rules can be designed and administered in a way that recognizes that there are honest mistakes made by well-intentioned people and that there are honest differences of opinion.

When mistakes are discovered, the rules ought to be structured and administered in a way that encourages self-correction of errors and without hesitation, causes people to promptly and confidently take the necessary steps to correct the mistakes through notification of the Service, paying any additional tax and interest, furnishing the information in the proper form or whatever else is required.

The current system is not working that way. Instead, taxpayers and third-party information providers are asking, after discovering errors, be they of omission or commission, what their exposure is vis-a-vis the penalty provisions. Responsible tax advisors have no other choice than to describe each of the penalties that could apply together with the potential amounts involved. A typical response to this penalty analysis is a cost/benefit analysis which in some cases factors in the odds on the Service learning of the mistake. It should go without saying that the opportunity for self-correction of an error is in too many cases foregone in the name of a "business decision." Using the carrot and the stick analogy, the stick is ominous and obvious. The question is, "where's the carrot?"

Mr. Chairman, We are not talking about those who set out to avoid or hurt the system. However, the current system produces a behavior which too often reaches the same result. That is clearly not the way it is supposed to work and equally clearly, it is totally contradictory to any notion of encouraging voluntary compliance.

The Service Draft marks a good beginning towards dealing with this serious impediment to improving compliance, with the following paragraph:

> "The information return system relies largely on the furnishing of accurate information by third parties. Because the tax system depends on the accuracy and timeliness of the information provided, the government should work with payors to encourage long-term compliance with these rules. The Task Force believes that penalties should not be a mechanism of first resort in achieving compliance. If a payor is trying to comply and has instituted reasonable business practices to assure compliance, penalties may not be appropriate. Rather, IRS should focus on educational efforts and other mechanisms for equipping and encouraging payors to accurately and timely provide needed information. Penalties, however, will still be an essential fixture to provide a necessary sanction for those who are otherwise unwilling to establish adequate systems, or who otherwise would choose not to comply because it would not be worth the expense to comply." (P.20)

Among its recommendations in the information reporting area, the Bar Report in referring to both specific and general information reporting penalty provisions, suggests that those provisions "should permit (or perhaps require) substantial abatement (i.e., reduction in amounts by 80 percent-90 percent) when 'first-time' offenders promptly provide data after notice from the Service, particularly when late information is likely to be useful to the Service. Penalty rates (or abatement policy) should be structured in such a manner that it is always in the taxpayer's interest to correct erroneous information."

I would urge that it is not only penalty rates and abatement policy but the total penalty system that should be restructured in a manner that makes it clear that it is always in the taxpayer's/payor's interest to correct erroneous information, while it is still useable by the Service--and the sooner, the better.

That is the guiding policy light that should be embraced by the Congress and the Treasury, as an incentive to those who are responsible for providing nearly one billion items of information for the use of the Internal Revenue Service and Social Security Administration. With this policy translated legislatively and administratively, Congress can and should expect on a recurring basis, increased revenues without increasing tax rates.

The concepts of self-correction of errors and "first-time" offenders are not synonymous. The Bar Report discusses the so-called "first-time" offender in the context of "after notice from the Service," suggesting substantial abatement. The Service Draft takes a more progressive approach, in stating,

> "Since the penalty system should educate the payor to voluntarily comply, first time offenders should generally be warned rather than penalized for not complying." (P. 21 of Service Draft).

In that context, a rule should be adopted that concludes abatement is appropriate where the taxpayer/or information provider represents, under the penalties of perjury, its past history of compliance in prompt reporting and paying and any other fact that is relevant to a positive record of compliance.

While the notion of positive incentives is largely foreign to our tax system and requires thoughtful research, there are steps which can be taken in the very near term that are measurable and more importantly, will demonstrably launch new incentives among the taxpaying population to more willingly participate in the system to the benefit of the Federal Treasury and therefore to the nation.

The current examples are few in number and limited in nature. For example, qualified amended returns (Regs. 1.6661-6(c)(2) and exceptions for corrected omissions (Regs. 301.6723-1T(c)(1).

The Service Draft offers some hope with statements such as "...it is not clear that deterrence requires all noncompliant taxpayers to be penalized....Given that the purpose of penalties is not to punish the noncompliant, the fact of noncompliance is an insufficient basis for the imposition of a penalty." (P.8)

This theme is carried forward and expanded somewhat in the information return penalty area wherein the Service Draft states, in part, "the Task Force believes that penalties should not be a mechanism of first resort in achieving compliance, if a payor is trying to comply and has instituted reasonable business practices to assure compliance, penalties may not be appropriate."

The Bar Report admittedly deals with information reporting in a limited way and this neither deals with the need for positive incentives nor does it go far enough in developing principles dealing with self-correction of errors. Its approach to substantial abatement practice for first time offenders after notification by the I.R.S. suggests endorsement of a policy of self-correction of errors.

Previous witnesses at these hearings have testified about the importance of information reporting, as an alternative to withholding, in serving an expanding role in compliance.

Short of adopting a policy of reimbursement for costs of information reporting, the following policies should be considered:

1. Where there is self-discovery of less than full compliance, timely action to self-correct should result in no penalty absent repetitive noncompliance. Timeliness would be determined based upon the period during which the information was still usable by the Service.

2. Where the noncompliance is discovered and brought to the taxpayer's attention by the Service, a single standard of reasonable cause should determine the appropriateness of a penalty. If "reasonable cause" has not been free of administrative problems, it pales in the face of due diligence, a standard that, similar to pornography, has proven controversial and difficult to define. But, unlike pornography, it has proven difficult for many to even recognize. Absent evidence of willful or intentional noncompliance, the notion of "first-time" offender should be employed to produce a written notification reviewing the requirements and informing the taxpayer that a record will be made of such notice.

3. A system based upon the notion of progressive punishment should be devised for those whose indifference, disregard or worse, results in repetitive or recurring acts of noncompliance. We need to make clearer distinctions through the rules between those who comply or make a good faith effort and those who do not.

As an analogy, many states keep track of motorists acts of proven or admitted violations. At pre-determined threshold levels, actions are taken up to and including suspension of driving rights. At the same time there is an incentive for changed behavior, e.g. eradicating the violations on one's driving record if there are no violations for a specified period of years.

In the information reporting area and beyond, as well, escalating dollar penalties and the promise of annual audits should have the desired effect in the particular case and probably beyond that if it is generally understood that those sanctions and actions are reality, not rhetoric.

This is not about amnesty, it is about fairness. It provides a system which comes closer to a "carrot-and-stick" approach.

Taxpayer Penalties

The other priority for penalty reform is the area of taxpayer penalties. The Bar Report's analysis of specific penalty problems are indirectly dealt with in the Service Draft with the notable exception of INTEREST.

In excluding this area from the scope of its study at least to this point in time, it does acknowledge the argument that the non-deductibility of interest to many taxpayers is, in effect, a penalty. This is probably an issue for another day.

The interest differential between what is due the government and what is due the taxpayer is a fairness issue. Both documents stress fairness as a critical criterion and the current statutory provision stands out as a symbol of unfairness in the system. It ought to be corrected.

The interest component of the negligence and fraud penalties together with the interest surcharge on so-called tax motivated transactions should be repealed. They are not appropriate on any grounds that would be used to construct a proper penalty system. The rate of the penalty should be set at a level high enough to achieve the objective, while eliminating unnecessary complexity.

The problem of overlap, pyramiding producing confusion, and complexity resulting in sanctions that are disproportionate to the conduct sought to be responded to, are well documented.

The Service Draft, if extended to the specifics of these problems would likely reach the same conclusions.

Fraud and Negligence

There is a principle that is common to both of these penalties which seems so contrary to the principles of American jurisprudence. It is the principle of presumptive guilt.

The Service Draft in defining fairness, sets forth these standards, two of which are relevant here.

> "Culpability. A penalty should be rationally related to the culpability of the taxpayer who is penalized. Only conduct that is noncompliant should be penalized...." (P.10, Emphasis Supplied)
>
> "Severity. A penalty should be severe enough to have the desired impact on compliant and noncompliant taxpayers, but should not be unnecessarily severe." (P.10)

I submit that both documents in their own way, support the elimination of the presumptive fraud provision.

The focus on fraud should not end there.

At a rate of 75 percent, the fraud penalty is not severe enough. While the government appropriately bears the burden of proof on fraud, when that burden has been sustained, the penalty should send out the strongest possible deterrent message. The penalty that I recommend as meeting the criteria that has been recommended in both documents would be a penalty akin to treble damages except in the interest of simplicity, I would recommend setting it at three times the tax due to fraud.

Another opportunity for less complexity and improved fairness is presented by the presumptive negligence penalty, or more accurately, the repeal thereof.

There are two particular problems with that provision. First, it formalizes and advances the notion among many taxpayers that the IRS views taxpayers as guilty until they prove themselves innocent.

As in the case of the fraud penalty, the negligence penalty should apply to the understatement attributable to the noncompliant behavior. The rate or rates would be adjusted accordingly.

Whether this is caused primarily by the Service, the Congress, or is a taxpayer-created perception, it is counterproductive and ought to be dealt with. Eliminating the presumption of negligence would be a positive step.

The second problem deals with the standard of proof, i.e., clear and convincing evidence. The overwhelming number of negligence penalties (nearly one million) are assessed against individuals who cannot be expected to be knowledgeable about or able to deal with what is a difficult legal standard to understand by taxpayers and to administer by the Service.

Elimination of the presumed negligence penalty together with upward adjustment of rates is supported in the ABA report and I believe widely supported for repeal.

Substantial Understatement Penalty

Perhaps the most controversial of taxpayer penalties is that imposed for substantial understatement. Other testimony has highlighted the objections to this penalty.

1. That substantial authority is a new standard (TEFRA 1982). The underlying statute provides little guidance as to its meaning or application.

2. There is no coordination with any other penalty other than for valuation overstatement.

3. The penalty is triggered by arithmetic rather than misconduct.

4. Congressional action to increase the penalty to 25 percent in 1986, and to do so retroactively for no apparent reason other than to raise revenue.

There appears to be some common ground between the two papers here, as well.

The Bar Report states, "...There is no legitimate reason why (he) should be penalized on the basis of additional tax....because of non-negligent reasons, such as a frank difference of opinion about the law...."

The Service Draft, in discussion of the problems, rather than stating its solution, noted that, "If a standard of care based upon disclosure of aggressive positions is necessary, issues arise regarding the definition of an aggressive position. Is a definition based upon substantial authority adequate? Certainly, such a standard is difficult for most individual taxpayers and particularly those who prepare their own returns, to understand. Further, for more sophisticated taxpayers, determining whether the standard is met can be a difficult and expensive proposition. On the other hand, if doubts exist as to whether the standard is met, the doubts can be addressed through disclosure."

The additional statutory language added by the Tax Reform Act has positioned the negligence penalty as a potentially far more influential and effective penalty. By revising the negligence penalty with rate differentials for differing noncompliance behaviors and the incorporation of a disclosure provision, the penalty for substantial understatement under Code Section 6661 would not be needed and should be repealed. This action would be consistent with the Service Draft discussion of the criteria which should be used to evaluate penalties and further supported by the majority view in the Bar Report.

The combination of proposed changes to the negligence penalty, including establishing tax rates for different levels of misconduct and incorporating a safe harbor disclosure requirement, when taken together with minority views on the substantial understatement penalty to (1) reduce the rate below the rate for negligence; (2) limit the requirement to substantial legal authority; and (3) eliminate disclosure for tax shelter transactions actually support repeal of Section 6661 since its application would be far more limited than it is today.

Anecdotal data suggests that the "disclosure" requirement as an alternative to substantial authority is the key to the effectiveness of the present statute.

Repeal would also help to establish the principle that there should be no liability without fault.

There is a growing sense of optimism that the Congress, the Treasury and the Internal Revenue Service are sincerely concerned about the current penalty problem and intend to change it for the better.

What the Service Draft and the Bar Report have accomplished is both a philosophical framework and a sufficiently detailed road map to take a small but significant step on the journey to fairness and simplification and with wide support.

Through these hearings, Mr. Chairman, you and your colleagues provide both leadership and a necessary forum.

As a taxpayer, I join you in the hope that your continuing examination of the penalty system will result in "...a fairer, more effective, and rational penalty system."

Mr. FLIPPO [presiding]. Thank you, Mr. Portney, for your testimony.

Mr. Schulze, do you have any questions?

Mr. SCHULZE. Mr. Chairman, again, other than to thank our panelists for their presentation, I do not.

Mr. FLIPPO. Thank you very much.

Gentlemen, we deeply appreciate your testimony and your patience.

Our next panel should please come to the table at this time, John Scrobola, chairman of the technical tax committee; Jonathan W. Allen, of the American Bankers Association; Hank Fischer; Nelson Stephenson; and Douglas Walker.

We are very pleased to have you gentlemen with us today and would be pleased to receive your testimony today. You may proceed as you deem appropriate.

STATEMENT OF JOHN W. SCROBOLA, CHAIRMAN, TECHNICAL TAX COMMITTEE, SECURITIES INDUSTRY ASSOCIATION, AND VICE PRESIDENT, MERRILL LYNCH, PIERCE, FENNER & SMITH

Mr. SCROBOLA. Mr. Chairman, members of the committee, my name is John Scrobola. I am a vice president of Merrill Lynch, and manager of its tax reporting services department.

I appear before you today as chairman of the Technical Tax Committee of the Securities Industry Association, the SIA.

SIA is a trade association whose members account for over 90 percent of the securities business transacted in this country and in Canada. With me today is Tom Vitez, the SIA's technical tax adviser.

We appreciate this opportunity to testify before your subcommittee on the subject of civil penalties. Our industry is heavily involved in and deeply committed to fulfilling our ever increasing recordkeeping, reporting and withholding responsibilities under the Internal Revenue Code. In my firm alone, we spent approximately $15 million in 1983 just gearing up for tax reporting. Currently, we employ 60 full-time personnel, plus an additional 65 at tax season just to comply with 1099 reporting requirements at an annual cost of $8 million.

We recognize the importance of the role of the third-party payers in insuring the integrity of the Federal income tax system. However, each year seems to bring new and increasingly complex reporting requirements which threaten to overload our manpower and systems capabilities. In many instances, the rules are unnecessarily complicated and burdensome because they are drafted by people unfamiliar with our operating environment and its limitations. Our written comments provide several illustrations of this problem.

The point I would like to stress here is that if the principal objective of the information reporting provisions of the code is to improve voluntary compliance, the best way to accomplish this is not through wholesale penalty assertions, but rather through consultation and collaboration between the tax writing committees of Congress, the IRS, and the payer community.

For example, IRS is currently gearing up for the issuance next fall of so-called B notices to over 20 million taxpayers with supposedly incorrect Social Security numbers. Recipients of these notices face backup withholding at the rate of 20 percent upon interest, dividends, and security sales proceeds unless they take immediate corrective action.

We are convinced that a large majority of these taxpayers have furnished their correct Social Security numbers to their payers and have fully reported their income to Uncle Sam. The problem lies in the IRS' definition of an incorrect TIN and in defects and inadequacies of the IRS programs and procedures. The appropriate solution is for the IRS and the payer community to jointly undertake a pilot study designed to narrow the issuance of these notices to truly noncompliance taxpayers.

In very brief capsule form, these are our principal recommendations:

First, under present law, payers are required to file information returns on magnetic tape. Those who file on paper are treated as not having filed a return and are subject to a $50 per return penalty. We submit that filing information returns on paper is a lesser offense than not filing at all, and warrants a lesser penalty.

Second, penalties should distinguish between late filing and returns not filed at all, and should be graduated to provide delinquent payers with an incentive to file while these documents are still useful to the Internal Revenue Service.

Third, penalties should continue to be based on the number of documents and not on the dollar amounts of income they reflect.

Fourth, the Internal Revenue Code should apply a uniform standard of conduct to all form 1099 filers, eliminating the distinction between interest or dividends and other categories of income.

Fifth, consider the repeal of the self-assessed penalties upon information return filers and, if retained, provide for a statute of limitations in this area.

Six, amend section 6656 of the code to eliminate retroactivity in the application of the recently enacted increase in the penalty for underpayment of deposits.

Seventh, and most importantly, require that the Secretary of the Treasury, in issuing regulations affecting entire industries and millions of taxpayers, to hold public hearings and assess their economic impact upon the private sector.

Mr. Chairman, I am available for questions.

[The prepared statement and attachments follow:]

STATEMENT OF JOHN SCROBOLA, ON BEHALF OF THE SECURITIES INDUSTRY ASSOCIATION

Mr. Chairman and members of the Committee, my name is John Scrobola, Vice President of Merill Lynch, Pierce, Fenner & Smith. On behalf of the Technical Tax Committee of the Securities Industry Association ("SIA"), I am pleased to testify before your subcommittee concerning the penalty structure under the Internal Revenue Code of 1986, as amended, (the Code) and the administration of these penalties by the Internal Revenue Service ("the IRS").

The Securities Industry Association ("SIA") is a trade association representing over 575 securities firms headquartered throughout the United States and Canada. Collectively, its members account for approximately 90 percent of the securities business transacted in North America. Its Technical Tax Committee addresses Federal tax developments, such as information reporting, withholding, recordkeeping, and other matters involving the tax compliance and administration required of securities firms.

Our association commends this subcommittee for devoting its time and attention to the much needed reexamination of the penalty structure contained in the Internal Revenue Code. We are also gratified by the ongoing efforts of the Internal Revenue Service to address this problem and are confident that these actions will culminate in the replacement of the present crazy quilt patchwork of penalties with a logical, fair, and consistent set of sanctions.

Our comments will focus upon the penalties associated with the information reporting requirements of the Code and with backup withholding under Section 3406 which, while technically not a penalty, in a practical sense has the same effect as a monetary penalty, particularly when applied to gross proceeds from the sale or redemption of securities. We are concerned with the impact of these provisions upon our industry, but even more importantly, we are concerned with the way in which the administration of these provisions by the IRS could subject a large segment of the 47 million individual investors of this country to bureaucratic red tape culminating in the imposition of withholding taxes and penalties even where no tax liability is evident.

Set forth below are our specific comments and recommendations for remedial action.

Structure of Penalties is Too Complicated

Effective tax administration requires a set of simple, clearly defined, and unambiguous penalties to stimulate compliance with the information reporting provisions of the law. Instead, as the attached table indicates, the statute prescribes an array of dissimilar penalties, depending upon: (1) the type of failure (i.e., failure to file, failure to furnish payee statement, failure to include correct information, and failure to supply identifying numbers); (2) whether or not the failure was intentional; and (3) the type of income covered by the document. Based on the foregoing criteria, the penalties per document are either a fixed amount (ranging from $5 to $100), or a percentage of the unreported income. The maximum assessable penalty per case also varies significantly, as does the method of assessment (self assessed or IRS imposed) and the standard for determining the applicability of available defenses (reasonable cause v. due diligence).

Having so many different rules apply complicates administration, promotes controversy, and undermines fair and evenhanded enforcement. We urge that these penalties be simplified and made consistent with each other. In this connection, the March 31, 1988 comments of the American Bar Association's Section on Taxation to this Subcommittee should provide a useful starting point for addressing the inconsistencies arising under present law.

Section 6721 Penalties Should be Restricted to Actual Failure to File Information Returns

Under the Income Tax Regulations, brokers must file all Forms 1099-B and, to the extent they file more than 50 documents, all Forms 1099INT, 1099DIV, and 1099OID on magnetic media. IRS takes the position that the failure to file penalty ($50 per document) applies to each document not submitted on magnetic media or filed late. (See IRS Publication 1220, Rev 7-87, page 1).

For a variety of legitimate reasons more fully discussed in our letter to the Internal Revenue Service dated June 11, 1987, a copy of which is attached, circumstances may arise requiring that some information documents be filed on hard copy instead of magnetic media.

In some instances, failure to comply is due to unreasonable requirements imposed by the IRS. For example, the specifications for reporting payments to domestic customers are different from the specifications applicable to foreign investors. This distinction, which appears to be without a valid rationale, requires firms to undertake an expensive and time consuming manual process to reformat their accounts. We have unsuccessfully urged IRS to standardize its requirements.

We submit that filing an information return on paper instead of magnetic media is a lesser offense than not filing at all, and warrants a less severe penalty, particularly where mitigating circumstances, such as IRS' own intransigence, are present. Accordingly, we recommend that the Congress enact a lesser penalty, say $5 per document, applicable to this infraction, and that it incorporate in the amendatory legislation the 5 percent de minimis rule suggested in our June 11, 1987 letter to IRS.

Penalties Should Distinguish Between Late Filing and Nonfiling

The existing information document penalties do not distinguish between returns filed late and returns not filed at all. In order to encourage filing of delinquent returns, the penalties should be graduated to provide delinquent payers with an incentive to file documents while they still serve a useful purpose in the hands of the Internal Revenue Service.

In this connection, it should be noted that processing by the IRS of information returns we are required to file during the first two months of the year does not generally commence until the following October. Also, in our experience, most instances of failure by securities firms to meet the filing date targets arise out of unforeseen computer systems related problems which are generally resolved well before October.

Penalties Should Continue to be Based on the Number of Documents and NOT on the Dollar Amounts Covered by These Documents

SIA does not agree with the suggestion that penalties should depend on the "tax harm" arising from failure to report - i.e. that a distinction be drawn between the failure to report small and large items. While an income or tax linked penalty may be appropriate when assessed against taxpayers who tend to benefit more from an undetected large error than a small one, it is completely inappropriate with respect to third party payers, whose noncompliance is rooted in causes unrelated to the income tax consequences of the omission or defect.

Dollar Cap

We recommend retaining the dollar cap on all information reporting penalties, so as to avoid imposing penalties which are clearly disproportionate to the offense. Consistency and fairness dictate that the dollar cap be applied uniformly to all Form 1099 income categories, including documents reporting interest and dividend payments, which are not capped under existing law. However, we agree that no cap should apply upon a finding of intentional disregard of reporting requirements.

Reasonable Cause v. Due Diligence

Present law and regulation impose more demanding standards of care upon payers of interest and dividends than upon payers of rents, royalties, nonwage compensation, etc. We believe that there should be a common set of rules for determining whether a taxpayer is entitled to an abatement or waiver of the penalty for failure to file information returns on time or for failure to furnish accurate taxpayer identification numbers on these returns. There appears to be no logical rationale for imposing stricter standards with respect to payments of interest and dividends (where compliance is relatively high) than on, say, compensation to independent contractors (where compliance is relatively low).

Self Assessment Penalties Should Be Addressed

Under current law, certain penalties imposed on information return filers must be self assessed. This requirement is bound to create confusion, uncertainty, and inconsistency, as taxpayers may be reluctant to assess penalties against themselves. Moreover, failure to file self-assessed penalty returns creates a condition whereby the statute of limitations never begins to run on the penalty, so that the IRS could impose it, with interest charges, at any time. The Congress should address this problem with a view to promoting fairness, compliance, and taxpayer certainty.

The Failure to File Penalty Should Not Apply Where the IRS Reporting Requirements are Unrealistic

The SIA believes that payors should not be subjected to penalties for failure to file information returns where the information required to be reported is unavailable to the payor.

Specifically, Treas. Reg. §1.6049-5T requires brokers and other middlemen holding certificates of deposit (CDs) and other instruments issued at a discount, as nominees for their customers, to file information returns reporting the original issue discount associated with such instruments on Forms 1099 OID. However, brokers are unable to comply with these requirements where the CD or other instrument is transferred in by their customers from other brokerage firms or is purchased in the secondary market, for the reason that the data elements required for the calculation of the reportable amount are not readily ascertainable. SIA has brought these problems to the attention of both the Treasury Department and the IRS, and has suggested remedial procedures, (notably the utilization of IRS Publication 1212) the adoption of which would permit implementation of the reporting provision. (See letters dated January 22, 1987 and July 9, 1987, copies attached). Similar problems exist with respect to "real estate mortgage investment conduits, or "REMIC's", and other collateralized mortgage obligations.

In both instances, the regulation writers have imposed reporting requirements which are unadministrable and which do not take account of the realities of the marketplace in which these instruments are traded and the constraints of the operating environment in which Forms 1099 are produced. We have repeatedly, albeit unsuccessfully, urged the IRS and the Treasury Department to collaborate with the financial community in developing reporting requirements which are compatible with our operating capabilities. Specifically, we requested time and time again that a joint task force be appointed, with membership drawn from systems analysts and data processing experts from both the Government and the payor community, to provide technical assistance for the regulation writers drafting requirements impacting upon the financial community. The consequence of the Government's refusal to heed this request has been the issuance of reporting requirements which simply cannot be implemented.

We recommend that the subcommittee address this issue with a view towards stimulating greater collaboration between Treasury and the payor community and providing statutory relief from penalties for failure to file information documents which cannot be realistically produced by virtue of the Government's own failure to put into place a mechanism making such reporting feasible.

The Treasury/IRS Interpretation of the "Due Diligence" Standard is Arbitrary and Capricious

The $50 per document penalty for failure to furnish a taxpayer identifying number on a Form 1099INT or Form 1099DIV is subject to the "due diligence" requirements. For pre-1984 accounts, the regulations prescribe an annual mailing requirement. However, these regulations take a totally unreasonable and punitive position holding the annual mailing requirement to be cumulative, with the result that if the payor fails to make the mailing in one year, but satisfies the requirement in all subsequent years, the payor is liable for the penalty under Section 6676(b) "with respect to the year in which the payor failed to make a mailing or makes a mailing improperly and all subsequent years (regardless of whether a mailing is made in a subsequent year) in which a return is filed with an incorrect taxpayer identification number," (underscoring supplied). See Treas. Reg. §35a.9999-3,Q & A78.

The regulations provide an avenue for relief for 1988 and subsequent years; however, no relief is provided for pre-1988 years. Thus, if the payor skipped a mailing in 1985, but complied with the requirements in 1986 and 1987, IRS will assert penalties for all three years. SIA believes that the Government's position is unreasonable and contrary to Congressional intent.

Civil Tax Penalties Should Not Be Retroactively Increased

Section 6656 of the Code imposes a penalty for failing to remit to an authorized government depository in a timely manner certain taxes withheld from payments to third parties (e.g. taxes withheld by a U.S. withholding agent under Code §§ 1441 and 1442 from certain payments to foreign persons). The Omnibus Budget Reconciliation Act of 1986 (the "Act") increased the Section 6656 penalty from 5 percent to 10 percent of the amount of taxes not deposited as of the deposit due date. The increased penalty was made effective for assessments made after October 21, 1986, the date the Act was enacted. Since the higher penalty was made dependent on the date of the IRS assessment rather than on the date the deposit or the relevant tax return was due, the increase in the penalty has a retroactive effect. Thus, the IRS can assess a higher penalty for a failure to timely deposit taxes that occurred prior to enactment.

We believe that it is fundamentally unfair to increase civil tax penalties retroactively. It allows the IRS to collect significantly increased penalties relating to tax periods for as many years back as are not barred by the statute of limitations.

The experience of a member firm illustrates this unfairness. The IRS imposed a 10% penalty in a 1988 assessment of untimely deposits made by the member firm in 1984, long before the increase in the Section 6656 penalty was ever considered by the tax writing committees of the Congress.

If the primary purpose of a civil tax penalty is to enhance voluntary compliance with the substantive tax laws, a retroactive penalty fails to serve this purpose. To have the desired effect, the amount of the penalty must be known with certainty prior to the occurrence of the acts that could trigger the penalty. Simply, a penalty that does not yet exist cannot deter improper conduct.

If the purpose of a retroactive increase in the penalty was to raise revenue, we are of the view that such a purpose is not a proper one for a civil tax penalty. It is likely to undermine the taxpayer's sense of the fairness of our tax system. The task of raising revenue for the operation of the government should be left to the substantive tax provisions.

For these reasons we believe that Congress should not retroactively increase civil tax penalties. Accordingly, a technical correction to Code §6656 to make the increased penalty effective only for underpayments of taxes that occurred after October 21, 1986 would be appropriate.

Backup Withholding Regulations Impose Unreasonable Requirements Upon Payors and Unfairly Penalize the Investing Public

On November 23, 1987, the IRS published temporary regulations (T.D. 8163) prescribing rules and procedures for the imposition of backup withholding due to notification of an incorrect taxpayer identification number (TIN). These regulations, which affect the entire financial community and potentially all interest and dividend recipients in the United States, were issued in temporary form -- i.e., without a public hearing and without an opportunity for interested parties to furnish comments. Moreover, in spite of their broad application, the Commissioner has determined that they did not constitute a "major rule," and therefore did not require a regulatory impact analysis. We recommend that the subcommittee review these regulations in their entirety, as an example of a Government agency's misuse of its authority to regulate the private sector.

The backup withholding tax is imposed by Section 3406 of the Code, at the rate of 20 percent, and applies to a variety of circumstances, including situations where the IRS notifies the payor that the TIN furnished by the payee is incorrect. While technically not a penalty but a creditable tax, backup withholding reduces the amount available to the taxpayer to spend or invest and, in effect, represents a compulsory interest free loan to the Government. Its adverse economic impact is especially severe when the withholding is applied to gross proceeds from the sale of securities. For example, the sale for $6,000 of securities costing $10,000, would require withholding a tax of $1,200 even though the transaction produced a tax loss of $4,000. Because of its severity, care should be taken to limit the imposition of the tax to situations where the taxpayer's culpability is clear cut - i.e., he furnished an incorrect TIN to the payor and he did not report the underlying income on his tax return.

The IRS regulations, however, go in the opposite direction and unfairly penalize millions of compliant taxpayers who accurately reported their income on their tax returns and who provided their payors with their correct TINs - in most cases under penalty of perjury.

The most objectionable feature of these regulations is their definition of an incorrect TIN as a case where either the name or the number provided on an information return does not match exactly the name and associated number on the records of the Social Security Administration (SSA). Thus, IRS will treat a number as incorrect, if the name of the payee on the records of the payor is at variance with the SSA's records, even though the taxpayer has provided his or her social security number to the payor and has certified as to its correctness by signing a Form W-9 under penalties of perjury. Given the large number of name changes due to marriage, divorce, remarriage, etc., delays in the processing of name changes by SSA, and the absence of a statutory requirement to report changes in names to SSA, the IRS' broad interpretation of an incorrect TIN will adversely affect millions of law abiding citizens. Added to the universe of "incorrect TIN" cases under the IRS definition of the term, are additional millions of individuals with hyphenated or foreign names, joint accounts, custodian or trusteeship accounts, and married women who retain their maiden names for employment purposes but use their married names for savings and investments.

Moreover, the IRS computers generate incorrect TIN notices based upon the match against the SSN records without a further comparison of the information returns against the related income tax records to determine if, in fact, the taxpayer had reported the income in question on his or her income tax return. This is manifestly unfair to compliant taxpayers, who are being penalized because of shortcomings in IRS and SSA programs and procedures.

SIA has repeatedly sought to work with IRS to reduce the volume of error cases through jointly conducted intensive studies focusing on a sample of cases identified by IRS as having invalid TINs. These offers have not been availed of, even though it is clearly in the best interests of both the Government and the securities industry to spare compliant taxpayers the red tape and economic hardship inflicted by these regulations. In any event, SIA recommends that your subcommittee urge the IRS to issue notices only in those cases where the income on the "invalid" Form 1099 is omitted from the related income tax return and that the Congress amend Section 3406(h)(8) and (9) of the Code to place responsibility for resolving an invalid TIN discrepancy upon IRS, rather than the payor, in situations where the latter has a Form W-9 on file from the payee which matches the name and SSN on the IRS notice. Accordingly, if a customer has furnished the broker with a certified TIN and the broker has utilized that number in reporting to the IRS, any further correspondence concerning the accuracy of that number should be directly between the Government and the taxpayer.

The temporary regulations impose a variety of other unreasonable requirements upon payors, including the duty to issue notices to customers within five business days after being notified by IRS or another broker that the customer has provided an incorrect TIN. The IRS generates these notices to payors on annual cycles, and it is not unusual for large securities firms to receive notices covering several thousand customers in one mailing. The following comment from one of our member firms illustrates the nature and magnitude of this problem:

> The five-day requirement is not only unreasonable (and it is certainly that), it is absurd. Only those firms that receive notification of but a handful of incorrect TINs will be _able_ to comply. For example, we have received two mass notifications of incorrect TINs in the past year and a half, each containing over 2,000 accounts. In order to complete a mass mailing to such a large number of customer accounts, the following steps would have to be undertaken:
>
> (i) Our information systems department would have to compare the IRS notice to our customer account records to confirm that our records and the Service's records agree. This process would be delayed at least a few days if the IRS provides only a hard copy (printed) list of incorrect TIN accounts (which was the case with the most recent incorrect TIN notifica tion to us), because the accounts on the IRS list then must be typed _by hand_ onto computer cards (or directly into the computer) and reviewed for accuracy before the extract program can be run and the extract produced.
>
> (ii) I also note that, beginning 1990, firms will also have to compare newly-received IRS lists with older lists to determine if an account has appeared on an incorrect TIN list twice in three years. _See_ Reg. Section 35a.3406-1(f), beginning on page J-20. This process will of course require additional time.
>
> (iii) After the extract is produced, it must be checked by hand to insure accuracy. With over 2,000 accounts, this process will require a few days at least. To the extent the

IRS list included substantially more than 2,000 accounts, more time obviously would be needed.

(iv) Once it has been determined that our records and the IRS records agree, the systems department will produce mailing labels, and copies of the IRS notification will be made.

(v) Lastly, the mailroom will collate mailing packages and send them out. If firms are required to send copies of IRS notices relating to specific customers, rather than a generic form message, this process will be tremendously slowed down, as the collators will have to match letters and mailing labels.

A further problem arises by virtue of additional and complicated rules which are triggered if a payee receives two notices of an incorrect TIN within a period of three years. Under the temporary regulations, payors are responsible for determining whether this condition exists; thus necessitating that each payor establish its own tracking mechanism to "run the clock" on these notices. SIA believes that it is unreasonable to require thousands of payors to build systems and procedures to track such notices. Instead, IRS itself should monitor these notices and notify payors at the appropriate time to implement withholding.

Another difficult procedure mandated by the regulations is the requirement to impose backup withholding on withdrawals made seven or more days after receipt of the incorrect TIN notice from IRS. All of our members' tax withholding systems are geared to payments going into an account. Thus, withholding upon disbursements, rather than receipts, would require major systemic modifications in programs and procedures. The Internal Revenue Service has announced last month that it will modify this requirement. We are in the process of evaluating the proposed change to determine if it will provide adequate relief to our industry.

Finally, we note that under IRS regulations, a broker is subject to a $50 penalty if he fails to obtain a certified TIN upon opening a new account, even if he imposes backup withholding upon all payments into the account. This punitive approach reflects an insensitivity to business realities, and should be reconsidered.

Conclusion

The securities industry has a long history of cooperation with the Congress and the Treasury Department in strengthening compliance with the tax laws. Our industry supported mandatory withholding on interest and dividends, and has devoted massive resources to implement the information reporting and withholding requirements of the Internal Revenue Code, the Treasury Regulations, and the administrative holdings of the Internal Revenue Service. The success of this effort is manifested by the many millions of complete and correct information documents filed by our member firms, which conform in every respect to the IRS specifications as to format and content.

While we are more than willing to cooperate with the IRS to identify and ferret out tax evaders, we believe that the regulations, programs, and procedures described above are largely misdirected at law abiding taxpayers. In our view, these cumbersome requirements will only create hardship and resentment, without any significant impact upon compliance levels. We urge that the Subcommittee prevail upon the Treasury Department and the Internal Revenue Service to work with the financial community - in a spirit of partnership and cooperation - to further improve the effectiveness of the information reporting system.

We also recommend that the Congress place limitations upon the authority of the Secretary to issue regulations affecting entire industries and millions of taxpayers without public hearings and without an assessment of their impact upon the private sector. Specifically, we recommend that the subcommittee review the authority of the Secretary to issue temporary regulations, and that it require proposed regulations affecting the compliance responsibilities of third parties to be subjected to a rigorous cost/benefit analysis.

We appreciate this opportunity to testify and are prepared to further assist the subcommittee in its efforts to improve the effectiveness of our system of tax administration.

SECURITIES INDUSTRY ASSOCIATION
120 Broadway, New York, N. Y. 10271 - (212) 608-1500

January 22, 1987

Legislation and Regulation Division
Office of Chief Counsel
Internal Revenue Service
Washington, D.C. 20224
Att: CC:LR:T (LR-2-86) and (LR-144-85)

Gentlemen:

The purpose of this letter is to submit to you the comments of the Technical Tax Committee of the Securities Industry Association (the "SIA")1/ with respect to Treasury Regulation Paragraph 1.6049-5T - ("the CD Regulations")2/ and IRS Announcement 86-130, 3/ which contains information reporting rules for brokers and other middlemen holding certificates of deposit (CDs) and other instruments issued at a discount as nominees for their customers. The letter also addresses the issue of applying the reporting rules set forth in the CD Regulations to stripped bonds and coupons. The Internal Revenue Service had requested comments from affected parties concerning both of these matters.

1. Certificates of Deposit

The CD Regulations amend the original issue discount reporting regulations under Section 6049 of the Internal Revenue Code to require the reporting of original issue discount (OID) on CD's held by brokers or other middlemen as nominees. The reporting requirements are effective for

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1/ The Securities Industry Association is a trade association representing over 500 securities firms headquartered in the United States and Canada, who collectively account for approximately 90 percent of the securities business transacted in North America.

2/ T.D. 8109, published in Federal Register 12/17/86.

3/ IRB 1986-52,22

instruments held on or after June 1, 1986. For calendar year 1986, the reporting requirements apply only to those CD's which the broker sold to the owner. For 1987 and subsequent years, brokers must report OID on all CD's held for customers, regardless of the manner of acquisition. Thus, CD's transferred in by customers from other firms or purchased in the secondary market are subject to the 1987 reporting requirements.

In Announcement 86-130 IRS states that it recognizes that brokers may not possess information sufficient to prepare Forms 1099 OID. The IRS proposes to deal with this problem by amending Section 1.6049-4 of the Regulations "to provide that a broker or middleman holding as a nominee a debt instrument described in Section 1.6049-5T(a) or (b) of the temporary regulations may waive its status as an exempt recipient and request that the issuer of the debt instrument provide it with a written statement setting forth the information required by Section 1.6049-3 of the regulations with respect to the debt instrument. In that event, the issuer will be required to provide a written statement to such broker." Thus, it is clear that brokers must compute and report the OID from sources other than IRS Publication 1212, which will not be expanded to include information on certificates of deposit.

We have carefully analyzed the relief procedure set forth in Announcement 86-130 and have concluded that it will not achieve its intended purpose of providing brokers and other middlemen with the information they need to meet their reporting responsibilities under the CD Regulations in a timely and accurate fashion.

The most obvious defect is one of timing. In order to comply with the Section 6049 mandated due dates for furnishing statements to payees and filing Forms 1099 OID with the Internal Revenue Service, nominees need to receive the information from the issuer well before the end of the calendar year. However, as we understand the procedures proposed in Announcement 86-130, they would merely require an issuer who had been served with a waiver to furnish a nominee with the payee copy of Form 1099 OID by January 31 of the following year, which coincides with the nominee's own due date for providing a statement to the beneficial owner. In short, the procedure allows no lead time whatsoever for data entry, computer processing, output review, and various other quality control procedures prevailing at most firms to minimize the incidence of error in the preparation of Forms 1099.

Another problem involves DTC eligible CD's registered in the name of CEDE and Co. These are issued in book entry form and the issuer has no record that the nominee is a holder of the instrument. Therefore, if the waiver procedure is to be effective, it would have to accommodate multi-tiered chains of ownership situations, thereby adding further complexities to the process.

Third, nominees obtaining possession of the instruments through the Automated Customer Account Transfer System ("ACATS"), described in our September 10, 1986 memo to Ms. Susan Himes of the TLC staff, may not have sufficient information in their files to accurately identify the security. This will occur where the issuer has outstanding more than one series of certificates with the same maturity date, but sold at different prices.

Fourth, and most importantly, the critical - and our view, insoluble -- shortcoming of the procedure is that it views the issue as an isolated problem, which can be dealt with on the basis of custom tailored manual procedures, when, in fact, it is an inseparable element of our firms' back office operations, involving the automated processing of hundreds of millions of items of information in an organized and systematic fashion. Consider, if you will, the problems of communication between the nominee and the issuer with respect to just one obligation. First, the nominee must identify the instrument requiring waiver of exempt status. Second, he must identify the issuer, and address a notice of waiver to this entity. Third, the request must reach the appropriate department or person in the issuer's organization who is capable of acting on it. Bear in mind, that there are no established channels of communication between the nominee and the issuer, so that the likelihood of the request being routed to the right person is remote. Assuming that the request does reach its intended destination, that there are procedures in place for processing the request, and that a copy of the Form 1099 OID is mailed out to the nominee in a timely fashion, the burden shifts to the latter, who must recognize the incoming document as requiring special processing and route it to the appropriate department. This department must calculate the yield on the CD, which is necessary to fulfill its reporting obligations, from the composite amount of OID shown on Form 1099 OID and code, edit, and enter the information into its data processing system, and integrate it with its computer programs generating the Form 1099 reports to its customers and to the IRS.

The procedures described above are totally incompatible with the constraints of the operating environment in which the Form 1099 statements are produced. A typical large retail brokerage firm processes hundreds of millions of security transactions annually and generates the various information returns required by IRS. For example, last year Merrill Lynch prepared 5.8 million year end tax statements to its customers, reflecting 12.8 million interest, dividends, gross proceeds, and other Form 1099 items reporting aggregate payments in excess of $108 billion. The procedures underlying the preparation of these reports are fully automated and involve formidable resources committed to systems design, programming, testing, error resolution, computer hardware, production and distribution.

The exponential growth in the volume of information returns filed by the payor community has been made possible solely by advances in the field of automatic data processing. Our ability to file and your ability to process over a billion information documents annually rests entirely on computer technology, which means that both you and we are bound together by the constraints of that technology as to what we can and cannot accomplish. Because of the overriding systemic and technical considerations involved, any regulations dealing with information reporting requirements must reflect the inherent limitations imposed by a computer driven processing environment. Failure to recognize this fact, as evidenced by Announcement 86-130, can only lead to bewilderment, cynicism, and reluctant noncompliance by a disillusioned payor community.

As we stated in our September 10 position paper to Treasury:

> "Announcement 86-22 [and by extension Announcement 86-130 and the CD Regulations, as well,] is defective in that it imposes a new reporting requirement without providing the means of implementation. If IRS wants information reporting of OID on negotiable CDs, it must also shoulder the responsibility for developing and prescribing a system which makes such reporting possible. Any solution must take into account that there are literally thousands of issues currently outstanding and that there are hundreds of new issues being created each and every week of the year."

Publication 1212 "List of Original Issue Discount Instruments" is an invaluable tool in implementing the OID reporting requirements. The logical solution to the CD reporting problem is to expand Publication 1212 to include certificates of deposit. Thus, issuers of publicly traded certificates of deposit issued at a discount should be required to file Forms 8281 in the same manner and subject to the same penalties as issuers of other OID debt instruments. The information contained in such forms should be included in Publication 1212. This will automatically insure their inclusion in the commercially produced magnetic tape versions of Publication 1212, which the industry uses to generate Forms 1099 OID.

Admittedly, adoption of the above recommendation will substantially increase the content of Publication 1212. If the volume of additional Forms 8281 to be processed as a result of this change and the resultant increase in the size of Publication 1212 presents administrative problems for IRS, the Government should utilize the services of commercial vendors to produce Publication 1212. SIA has explored this approach with the vendor of the computerized version of Publication 1212 which our industry uses. We have determined that this vendor is prepared to take over the production of Publication 1212 by compiling listings from Forms 8281 filed with IRS and delivering both tape and hard copy versions to users. Of course, taking the commercial route, could well require overcoming disclosure problems which might arise under Section 6103 of the Code.

Finally, reporting on CDs transferred in or purchased in the secondary market should be imposed prospectively. Accordingly, CD issues currently outstanding should be grandfathered and held exempt from reporting by brokers and middlemen who are not issuers of the obligations.

2. Stripped Coupons and Bonds.

We strongly recommend retention of the present procedure for reporting OID on stripped coupons and bonds. The present system, whereby the OID to be reported under Section 6049 of the Code for stripped interest and principal components of U.S. Treasury securities or similar instruments backed by U.S. Treasury securities is computed by the Treasury and published in Section II of Publication 1212, is efficient and effective in providing payors with the information they need to file timely Forms 1099 OID with respect to such instruments.

Unlike the CD reporting procedure discussed above, inclusion of this information in Publication 1212 poses no processing or space problems for IRS. Applying the time honored aphorism of "if it ain't broke, don't fix it" to the proposal, it is clear that the existing rules and procedures should continue to prevail.

The proposal to require OID reporting on stripped instruments with reference to the current inclusion rules of Section 1286 received extensive study and analysis by an SIA ad hoc committee in 1985. See our letter dated September 5, 1985, addressed to then Assistant Secretary Ronald Pearlman, copy attached. The rule currently in effect reflects Treasury's adoption of Alternative 1 presented therein.

We continue to believe that Alternative 1 represents the most practical and cost effective approach. If a more precise reporting mechanism is called for, Alternative 2 offers an elegant, if costly, solution you may wish to adopt.

SIA's Technical Tax Committee would be glad to meet with Treasury and IRS staff to discuss these matters further.

Respectfully submitted,

John W. Scrobola, Chairman
Technical Tax Committee

JWS/aj

SECURITIES INDUSTRY ASSOCIATION
120 Broadway, New York, N. Y. 10271 · (212) 608-1500

June 11, 1987

Mr. Lawrence Gibbs
Commissioner of Internal Revenue
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Dear Commissioner Gibbs:

The securities industry is responsible for filing several hundred million information returns annually with the Internal Revenue Service. All but a very small portion of these documents are submitted in magnetic media mode. The relatively few documents filed in hard copy form are invariably created on an exception basis and are attributable to unforeseen and unavoidable circumstances beyond the payer's control.

In general, the filing of these documents on paper trigger the assertion of penalties under Section 6652 of the Internal Revenue Code. While the Regulations authorize you to waive the magnetic media reporting requirements upon a showing of hardship, we find this relief provision inappropriate and unhelpful. The purpose of this letter is to demonstrate why the existing criteria for granting waivers are not responsive to our needs, and to request that the Service revise its procedures to accommodate the situations which prevent our infrequent and reluctant noncompliance with the magnetic media filing requirements.

Under the currently prevailing rules, a payer seeking a waiver must prove hardship and must file its request at least 90 days before the filing of the returns involved. Further, in determining whether hardship has been shown, the principal factor to be taken into account is the amount, if any, by which the cost of filing returns on magnetic media exceeds the cost of filing the returns in hard copy form. However, for most securities firms, the necessity of having to file certain Forms 1099 on paper is ordinarily triggered by factors unrelated to cost considerations, and generally occurs well beyond the deadline for filing the request.

The following examples illustrate the typical circumstances surrounding the submission of paper documents:

Example 1

Firm A uses an outside service bureau to prepare its Forms 1099 for submission to the IRS. For 1986 it filed approximately 200,000 returns on magnetic tape. In December 1986, A acted as an investment banker and broker in public offering of stock in the Y Company which also involved the sale of common stock for 125 existing shareholders of Y. The sale was an isolated transaction and was not processed through its normal brokerage operation. Therefore, the ordinary procedures for generating magnetic tape information returns were not available. Also, because the transaction occurred in late December, and the due date for filing the returns was February 28, A could not meet the 90 day deadline for filing the request.

Example 2

Firm B also uses an outside service bureau and files more than 100,000 Forms 1099 annually. However, the service bureau is not equipped to handle certain specialized transactions, such as installment sales of publicly traded stock, which under the rules in effect for tax year 1986, could be reported on the installment basis. Since these are non-routine transactions requiring specialized procedures and involve a small number of returns (200), they were filed in hard copy form.

Example 3

Firm C filed 3 million information returns on magnetic tape. In addition, it filed 500 documents on paper and 100 of these represented amended Forms 1099 DIV and INT correcting errors identified subsequent to filing the originals on magnetic tape. The remaining 400 were Forms W-2P and 1099R, out of a universe of 14,000 and 7,000, respectively, which could not be filed on tape due to internal systems problems.

Example 4

Firm D filed 2,400 Forms 1099 on magnetic tape and 100 documents on paper. The latter included: (1) additional items discovered after the submission of the magnetic media, (2) items which had been excluded from the magnetic submission because of computer errors and which could only be recreated manually, and (3) transactions associated with new products which were to be integrated with the firms' tape reporting system. However, due to programming problems encountered along the way these systems design changes could not be completed by the filing due date.

As the foregoing examples illustrate, payers frequently encounter unanticipated problems or special situations which result in the filing of hard copy information returns under circumstances where applying for a waiver is impossible or impractical. As a result, these paper filings trigger the $50 per document penalty under Section 6652 of the Code. While the Service will often abate such penalties upon a showing of due diligence by the payor, these case by case determinations are time consuming for both IRS and the payor, and also frequently result in a lack of uniform treatment of similarly circumstanced taxpayers.

We recommend that the IRS procedures be revised to grant automatic relief from the penalties under Section 6652 of the Code to magnetic tape filers who submit a small percentage of their information documents, say less than 5 percent of the total volume, in hard copy form. Adoption of this proposal would provide equitable and across the board relief to the overwhelming majority of payors who are essentially in full compliance with the reporting requirements. It would also generate savings to IRS due to reduced workloads in processing waiver applications and penalty abatement requests filed by payors.

We believe that these benefits to the payor community and to IRS would be realized without impacting negatively on voluntary compliance, since most payers affected by the proposal would be able to demonstrate due diligence and obtain relief from the Section 6652 penalty assertions in any event.

Our committee would be glad to discuss this proposal further with the appropriate members of your staff and to provide any additional information you may require.

Sincerely yours,

John W. Scrobola, Chairman
SIA Technical Tax Committee

cc: Assistant Commissioner Pecorella

SIA SECURITIES INDUSTRY ASSOCIATION
120 Broadway, New York, N. Y. 10271 · (212) 608-1500

July 9, 1987

Richard D'Avino, Esq.
Deputy Tax Legislative Counsel
United States Treasury Department
15th and Pennsylvania Avenue, N.W.
Room 4013
Washington, D.C. 20220

Re: Information Reporting For Brokers and Other Middlemen Holding Certificates of Deposit Issued at a Discount as Nominees for Their Customers

Dear Mr. D'Avino:

The purpose of this letter is to summarize the proposal of the Technical Tax Committee of the Securities Industry Association with respect to information reporting for brokers and other middlemen holding certificates of deposit ("CD's") issued at a discount as nominees for their customers. As discussed at a meeting on June 8, 1987 in your office, this proposal is intended to replace the rule contained in Announcement 86-130, 1986-52 I.R.B. 22, which provides that the Internal Revenue Service will amend Treas. Reg. §1.6049-4 to provide that a broker or other middleman holding a CD as nominee may waive its status as an exempt recipient and request that the issuer of the CD provide it with a Form 1099-OID.

PROPOSAL

The regulations under Section 6049 of the Internal Revenue Code (the "Regulations") would be amended to provide

1. Within 30 days after the effective date of the Regulations, as amended, the issuer of any CD which is outstanding on the effective date (or its agent) shall provide the following information to each registered owner of an interest in the CD that is an exempt recipient described in Section 6049(b) (4) of the Internal Revenue Code and the regulations thereunder (an "exempt recipient"):

(a) CUSIP Number, if any,
(b) Issue Date,
(c) Maturity Date,
(d) Issue Price (as a percentage of principal amount),

(e) Annual Stated Interest Rate, if any,
(f) Ratable Daily Portion of Original Issue Discount ("OID") (Dollar Amount per $1,000 of Maturity Value in each Accrual Period), and
(g) OID to be Reported Per $1,000 of Maturity Value for Calendar Year (the "OID Information")

If all or any portion of the CD is held by a depositary (such as the Depositary Trust Company) or the nominee of a depositary, the issuer (or its agent) shall provide the OID Information to the depositary (or its nominee) within 30 days after the effective date of the Regulations, as amended.

2. Within 30 days after the issuance of a CD, the issuer of the CD (or its agent) shall provide the OID Information to each initial purchaser of an interest in the CD that is an exempt recipient. If all or a portion of the CD is held by a depositary (or the nominee of a depositary), the issuer (or its agent) shall provide the OID Information to the depositary for (or its nominee) within 30 days after the issuance of the CD.

3. Within 30 days after the registration of the transfer of an interest in a CD on the books and records of the issuer (or its agent), the issuer (or its agent) shall provide the OID information to any transferee who is an exempt recipient.

4. A depositary (or nominee of a depositary) which receives OID Information from an issuer of a CD (or its agent) shall provide to each of its members in June and December of each year all the OID Information it has received with respect to all the CD's it holds or has held in the preceding six months for its members.

5. Any information which the issuer (or its agent) or the depositary (or its nominee) is required to provide under the Regulations shall also be provided to any person upon request at any time.

6. The reporting requirements of the Regulations for CD's that were not originally sold by the broker will be effective for CD's acquired by the broker on or after the effective date of the Regulations, as amended.

7. A broker or other middleman holding a CD as nominee shall be entitled to rely on the OID Information it receives from the issuer (or its agent) or the depositary (or its nominee) in determining whether the CD is one which was issued as a discount and, if so, the amount of OID which is includible in income of the holder.

The Technical Tax Committee would be happy to discuss this proposal with you at your convenience.

Very truly yours,

John Scrobola

John Scrobola
Chairman, Technical
Tax Committee

cc: Susan Himes, Esq.
Attorney-Advisor
United States Treasury Department
15th and Pennsylvania Avenue, N.W.
Room 4015
Washington, D.C. 20220

Mr. **Flippo**. Thank you very much.

I believe we would have further testimony before we come back to questions at this time.

Who would like to proceed next? Mr. Allen.

STATEMENT OF JONATHAN W. ALLEN, SENIOR VICE PRESIDENT AND DIRECTOR OF TAXES, THE WACHOVIA CORP., WINSTON-SALEM, NC, ON BEHALF OF THE AMERICAN BANKERS ASSOCIATION

Mr. **Allen**. Mr. Chairman, I am here representing the American Bankers Association, which is the trade association for the commercial banking industry. Its membership represents 95 percent of the banking industry assets. There are approximately 12,000 members. I might point out that approximately 10,000 of them are what we would call small banks.

I am going to focus this morning on the penalty provisions concerning information reporting and their interaction with the taxpayer identification number matching program and backup withholding rules.

Over 1 billion information returns were filed last year. Commercial banks filed a significant portion of those. My own institution filed 1.5 million information returns. As such, the information reporting penalties are very familiar to the commercial banking industry.

Since 1983 through today, the regulations and rules on information reporting and backup withholding have been constantly changing. These changes have been done without regard to the impact upon information reporters as to the cost or timeliness, and are often, as alluded to earlier, written without any real feel for what goes on out in the business world.

These regulations are often temporary or in question and answer form. Therefore, they do not permit a comment period. It was not until 1988 that we had a more or less temporary set of regulations published for the entire field of information reporting.

At least 13 different penalties may be applicable to the information reporting area. I must say these are viewed as more or less arbitrary and capricious. Even with major good faith compliance, it is practically impossible to not run afoul of one of these penalties.

The fear of these penalties does in fact restrict business development, in that customers may be faced with refusal to accept a bank deposit if they do not provide their taxpayer identification number.

In order to avoid a penalty, one of the ways is to close the account, which doesn't create good customer relations, and frankly may force the customer into more elaborate steps of hiding income.

A further irony may be that this could encourage information reporters to not file when they have incomplete information from the customer in order to avoid the automatic assertion of a penalty. I don't know that this has happened, but it certainly could possibly occur to someone.

We are penalized for failing to provide the IRS information, such as the customer's taxpayer identification number, that we can only obtain from the customer.

In order to avoid that penalty, we have to follow a detailed set number of steps. We have to prove that we solicited that number annually from the customers; we have to withhold on cash withdrawals made after seven days; we have to withhold on all earnings credited to the account after 60 days. One of the other alternatives to avoid the penalty is to close the account.

There are some other ways that you can avoid the penalty, however, they are just about as complex if not more so.

If everyone of these steps is not performed and documented, the bank has not performed due diligence, and is penalized. Yet, the customer has control of the information.

There is a penalty that is applicable to the customer for their failure to provide us with a taxpayer identification number. We have seen little or no evidence of IRS enforcement of that provision. Yet, the IRS is vigorously applying penalties to financial institutions and other information reporters.

There is more or less a zero tolerance rule in these areas. And errors are going to occur. Just the sheer volume will ensure that errors are going to happen.

I would like to give you some sample percentages from one financial institution.

In opening an account, setting up a new account at a bank, one financial institution experiences a 1.4-percent error rate.

On a name change, the error rate is 6.5 percent.

On address change, the error rate is 3.1.

Now, these are not final error rate percentages because there are quality control checks that attempt to reduce those error rates and catch them. So, in reality, they are somewhat lower. But each one of those, in connection with an information return, could create a penalty.

At my institution, we open 200,000 new accounts a year. We have 95,000 name changes. We have over a quarter of a million annual address changes. In our case, that penalty would be $1.2 million.

And I am sure this committee is aware that the IRS makes errors in processing returns, advising taxpayers, and in the audit and collection function. We are all human, and unintentional errors will occur. We would like, therefore, to recommend the establishment of a safe harbor error rate. This threshold might be similar to something on the order of the IRS return processing error rate. I do not know what that is.

We would also like to recommend that there be created an IRS information reporting task force made up of people from information reporting industries and IRS policy representatives. These meetings should be open to the public with publication of the meeting results.

The third recommendation is direct the IRS to enforce existing penalties against taxpayers who failed to furnish accurate taxpayer identification numbers. And with that, limit the annual due diligence mailing, the so-called vaccination against penalties, to two annual mailings. If the bank doesn't get a taxpayer identification number after the second mailing, chances are it is not going to get it with the third or fourth, and that's very expensive.

Four, require all changes in IRS information reporting regulations and requirements to be issued prior to October 1 of the preceding year. For example, no changes after October 1, 1988, for information returns to be filed with regards to 1989. This would enable information reporters to comply by making any system changes, to educate their personnel, and to disseminate the technical aspects of that change across their institution.

Five, require IRS to use the information reporting name and address shown on the tape document where we are transmitting information returns to the IRS. Frequently the contacts come back to the bank addressed with just a street address. When they come in, our mailrooms do not know which area gets it and they float around the bank, and there is a time frame running on these things requiring action by the bank.

Sixth, centralize IRS information return processing and the taxpayer contact functions. We think this would facilitate the IRS enforcement of the information reporting programs. It would improve IRS response to question because, currently, there is a lack of knowledge about information reporting, taxpayer identification number matching, and backup withholding in the district offices.

I appreciate the opportunity to comment on these information reporting penalties, and will be happy to try to answer any questions you may have.

[The statement of Mr. Allen follows:]

Testimony of the American Bankers Association
before the
Subcommittee on Oversight
of the Committee on Ways and Means
U.S. House of Representatives
July 28, 1988

Mr. Chairman and Members of the Subcommittee, I am Jonathan W. Allen, Senior Vice President and Director of Taxes, First Wachovia Corp., Winston Salem, North Carolina. I am appearing today on behalf of the American Bankers Association ("ABA") and presently serve as a member of the ABA Taxation Committee and chairman of its subcommittee on Tax Compliance. The American Bankers Association is the national trade and professional association for America's commercial banks of all sizes and types. Assets of ABA member banks are about 95 percent of the industry total.

The Subcommittee's action to review the Internal Revenue Service ("IRS") implementation of the penalty provisions of the tax code is as important as it is timely. Similar action is also underway by your counterparts on the Senate Finance Committee. I am pleased to be a participant in those activities as a member of Senator David Pryor's Private Sector Penalty Task Force. Indeed, similar efforts are being made by the Tax Section of the American Bar Association and, perhaps most encouragingly, by an advisory group to the IRS Commissioner. All of these efforts reflect the fact that IRS penalty provisions have become too numerous and confusing and, in many cases, are not implemented in a fair and equitable manner.

My testimony this morning will be directed primarily at the IRS penalty provisions concerning information reporting, taxpayer identification number ("TIN") matching, and backup withholding. I would also like to make a brief comment about the enactment of penalties; in specific, the retroactivity of penalty rates.

The IRS received nearly one billion information returns last year, with hundreds of millions of those being filed by commercial banks and other financial institutions, on all types of interest bearing deposit accounts, mortgage interest payment accounts, broker transactions where the bank plays a role as middleman for a transaction between two customers, and many other types of transactions. All this effort places commercial banks in the position to be very familiar with the IRS' implementation of the penalty provisions related to information reporting and backup withholding.

Mr. Chairman, some people may recall the lobbying by information reporters and their customers in 1982-1983 against mandatory withholding on deposits and conclude that we have no room to complain now about the implementation of the alternative system. The commercial banking industry recognizes the importance of IRS and Congressional efforts to close the tax compliance gap through the TIN matching program and backup withholding. Indeed, the commercial banking industry has done as much as any group to further the effort to have a clean system of TINs and to provide to the IRS information that would enable them to track down tax cheats. Banks all over the country have made annual "due diligence" mailings to customers seeking certified TINs, revised their computer systems to implement backup withholding, trained personnel about how the IRS rules affect procedures for opening accounts and handling window transactions, tracked down apparent incorrect TINs in response to IRS "B" notices (TIN does not match social security records) and "C" notices (customer has underreported interest and dividends), etc. The commercial banking industry has expended a vast amount of monetary and human resources in attempting to comply with the IRS information reporting as well as backup witholding regulations. This effort has been carried out under a continuingly changing set of IRS temporary rules isssued in fragmented question and answer form over the past five years. It is only this year that the IRS would say that at least a temporary set of all the regulations are now published.

The IRS' implementation of the TIN matching program and the backup withholding system has been perceived by information reporters, however, as arbitrary and divorced from reality. Penalties applied in cases where banks have made an enormous effort to comply with the law appear unfair. Indeed, the system seems to be overrun with penalties. Take for example the penalties that might be applied on the bank in connection with a simple savings account.

* Failure to file with the customer - $50 per return, no maximum.

* Failure to file with the IRS - $50 per return, no maximum.

* Failure to timely file with the customer - $50 per return, no maximum.

* Failure to provide a correct taxpayer identification number on the form filed with the IRS - $50 per return, no maximum.

* Failure to provide a correct taxpayer identification number on the form filed with the customer - $50 per return, no maximum.

* Failure to provide correct information to the IRS - $5 per return, no maximum.

* Failure to provide correct information to the customer - $5 per return, no maximum.

* Failure to file on magnetic media - $50 per return, no maximum.

* Failure to file on machine-readable forms - $50 per return, no maximum.

* Failure of a broker to provide the notice to payor regarding backup withholding - $500 per occurrence.

* Failure to backup withhold - the amount that should have been withheld.

* Failure to deposit taxes withheld - 10% of the underpayment.

* Intentional disregard of the requirement for filing information returns - the greater of $100 or 10% of the interest required to be reported.

In addition, interest accrues on outstanding but unpaid penalties at the prescribed rate.

The implementation and enforcement of these penalties are egregious. The IRS imposes penalties on banks for failing to provide information that only the customer can provide or verify. The IRS needs to recognize that there are limitations on a bank's ability to obtain TINs from customers. Upon the opening of an account, a bank requests a TIN (social security number or employer identification number) from a customer, and either obtains a certified W-9 or an awaiting TIN certification. The bank applies backup withholding when a customer fails to later provide his TIN within 60 days. The bank should not be penalized for failure to include a TIN with the information return; provided, the bank commences backup withholding upon the expiration of the 60 days. Congress has already provided the IRS with the authority to apply a penalty upon the customer in this situation; but so far, the IRS has failed to exercise that authority with the same diligence as the IRS uses in monitoring the banks. Direct contact with the taxpayer would be more effective in getting correct TINs; however, the IRS finds it easier to levy a penalty on the bank rather than further the objective of a voluntary compliance system by getting the necessary information directly from the taxpayer/customer.

For example, consider the new due diligence requirement in opening new accounts. As of January 1, 1988, if a bank opens a new account and the customer gives the bank an awaiting-TIN certification, but fails to provide the bank with his certified TIN before the end of the 60 day period, the bank must begin backup withholding. Unless the bank monitored the customer's account during this 60 day period for any cash withdrawals after 7 business days following the receipt of the awaiting-TIN certification and performed backup withholding on these payments or the bank closes the customer's account on the 61st day, the bank will be subject to the $50 penalty when it files the information return because the customer failed to supply his TIN. The penalty is imposed even though the bank withheld on all interest credited to the customer after the expiration of the 60 day grace period. The bank has effectively been penalized for the customer's failure to supply his TIN; yet, the bank has taken all reasonable steps to secure the TIN. The only alternative to avoid payment of the $50 penalty is to close the customer's account on the 61st day--a policy that will not endear the bank to its customers. In addition, it is the IRS' position (though not specifically addressed in the regulations) that the bank will be liable for any taxes that should have been withheld under this requirement. In effect, the IRS regulations dictate that a bank should not open any account without a number (even though this option is not always available in a non-deposit type relationship), thereby frustrating the statutory concept of exempting a person from withholding when they are waiting to receive a TIN.

Penalties are applied by the IRS for incorrect TINs where the bank failed to perform "due diligence" to the nth degree. For example, a large bank with hundreds of branches undertook all of the separate mailings, revised all of its computers, trained personnel about new procedures for opening accounts, etc. at a cost of several million dollars. It discovered however, that at one office for a period of about six weeks, new accounts were opened without obtaining the requisite W-9 form. As a result, the responsible bank officer could not certify, under the penalty of perjury, that due diligence was performed on every account, although clearly a system-wide compliance had been achieved. Nonetheless, the IRS applied a $500,000 penalty on the bank for missing or incorrect TINs. Surely there should be some recognition for substantial compliance. Due to the number of returns required, a constantly changing customer data base, the seemingly continuous changes to the tax laws and regulations, and the human factor, returns will be filed with inaccurate information. This, however, should not be considered an indication that the failure to include correct information is due to any intentional disregard of the correct information reporting requirements. Currently, the IRS holds information reporters to a "zero tolerance" level. This is unfair and inequitable.

The banking industry recommends that the IRS hold information reporters to the same level of accuracy that the IRS experiences in its return processing and its dealings with taxpayers. Employees for the banking industry and the IRS are human and as such, errors will occur. Thus, no reporting system can reasonably be expected to function error-free. Therefore, if the Service can accept less than 100% perfection from its employees, information reporters should be provided similar consideration--especially, in those instances where only the customer can provide the information. As the IRS Task Force for the Commissioner's Penalty report states, penalties should not be a mechanism of first resort in achieving compliance on information reporting. Penalties imposed on taxpayers making every effort to comply blur the distinction between compliant behavior and non-compliant behavior; thereby discouraging taxpayers from doing their best to comply since they believe the penalty is inevitable. If a payor is trying to comply and has instituted reasonable business practices to assure compliance, penalties are not appropriate. Therefore, the banking industry recommends that the IRS revise its penalty structure to incorporate an acceptable error deviation factor for filers of informations returns.

Additionally, I would like to bring to your attention a totally unprecedented retroactive increase in the penalty rates applicable to late deposits of withheld taxes that was added to the Code by the Omnibus Budget Reconciliation Act of 1986. This provision doubles the previous penalty for late payment of withholding tax deposits from 5% to 10% for all penalties assessed after October 21, 1986, and without regard to the tax years for which they were imposed. Unless the "reasonable cause" exception applies, the penalty is due if the deposit is as much as one day late. Yet, the penalty amount (10% of the overdue balance) is the same whether the deposit is one day late or several months late. Moreover, this penalty is in addition to the interest customarily imposed on late payments. The statute of limitations and the interplay of IRS audit practices further aggravate this situation. It is reasonable for one to imagine that the normal three year statute of limitations on assessments of taxes and penalties would be sufficient time for the IRS to audit a tax return and for an information reporter to exercise his rights to administrative review--however, this is usually not the case. As a matter of course, IRS auditors request extensions of statutes of limitations, and information reporters have no choice but to sign them if they wish to exercise their administrative review rights before a tax or penalty is assessed and paid. It is not unusual (particularly in the case of large corporations filing complex returns) for more than five years to elapse between the date a tax return is filed and the date on which the tax or penalty is actually assessed. If the penalty is assessed after October 21, 1986, the 10% rate applies no matter how long before that date the tax return was filed. The retroactive increase in the penalty rate is especially onerous in situations where the taxpayer already made the required deposit before the assessment is prepared by the IRS.

At this time, I would like to make recommendations that reflect the banking industry's desire to work with Congress, the IRS and taxpayers to create an information reporting system that is fair and equitable. Specifically, the banking industry recommends:

*Establish an acceptable error rate for information reporters comparable to the error rate the IRS expeiences in its return processing in lieu of the current "zero error" tolerance level.

*Create an IRS Information Reporting Task Force to meet quarterly with the industries that are the principal information reporters for the purpose of reviewing, at a policy level, the implementation and administration of the information reporting program. Consistent with the Government in the Sunshine Act, these meetings should be open to the public with regular minutes taken, and results of the meeting published.

*Direct the IRS to use the authority given to them, by Congress, to pursue taxpayers who have failed to provide accurate and certified TINs. This is a more effective way to go after those taxpayers who have been unwilling to comply with the TIN program. The due diligence responsibility of information reporters should be limited to two annual mailings requiring W-9 certification; although, information reporters would still be required to backup withhold on these taxpayers' accounts.

*Require all changes in IRS information reporting regulations and requirements to be issued prior to October 1 of the preceding tax year so that information reporters have ample time to implement the changes as well as educate their personnel. In a related matter, any information reporting regulations that the IRS issues must be in proposed form with an accompanying comment period. Temporary regulations should have a mandated life span of one year--after which they will be considered proposed (with a comment period) unless they are issued in final form within that one year span.

*Require the IRS to use the name and address on the transmitter file as the contact address for IRS' mailings to information reportes. The IRS' current use of the information reporters address from income tax and other returns delays the ability of information reporters to comply with IRS' requests.

*Centralize IRS information return processing at a single service center. This would facilitate the IRS' enforcement of the TIN program as well as improve the IRS' responses to questions from information reporters and taxpayers.

*Enact legislation that would designate the effective date of the 10% rate to deposits which were required to be made subsequent to October 21, 1986.

On behalf of the ABA, I appreciate the opportunity to comment on information reporting penalties. The banking industry is willing to work with Congress, the IRS, and other interested parties in developing important and timely legislation. If you need any further information, please contact me at (919) 770-5556 or Henry Ruempler, Tax Counsel for the ABA, at (202) 663-5317.

Mr. FLIPPO. Well, thank you very much, Mr. Allen, for your testimony.

Mr. Fischer.

STATEMENT OF HANK FISCHER, VICE PRESIDENT, DIRECTOR OF PUBLIC AFFAIRS, TCF BANKING & SAVINGS, MINNEAPOLIS, MINN., ON BEHALF OF THE UNITED STATES LEAGUE OF SAVINGS INSTITUTIONS

Mr. FISCHER. Thank you, Mr. Chairman. My name is Hank Fischer, vice president and director of public affairs for TCF Banking and Savings in Minneapolis, MN. I am here to represent the United States League of Savings Institutions in addressing a number of the issues that you are looking at today.

Frankly, we support the Internal Revenue Service's efforts to make sure that taxpayers do not intentionally underreport, and to strengthen the procedures supporting that whole effort. Nevertheless, we hope that this subcommittee will move to make the necessary changes or statutory changes so that the IRS can scale back the excessive policing activities and the punitive assessment of fines and penalties that currently exist in the TIN compliance and information reporting regulations.

To reiterate, we support that whole information reporting and backup withholding concept. Nevertheless, the IRS has made it unduly complex and has established very excessive penalties for failures or for even minor mistakes. There's no proportionality in the system today. A small mistake can be penalized just as heavy as a major mistake. And we think that needs to be changed.

Now, I have to tell you that the IRS did make a number of changes during the last year that have improved a couple of minor points that were brought to their attention earlier. For example, they eliminated a TIN compliance rule at four savings institutions to either close awaiting TIN accounts opened in 1988 without certified TINs, or incur penalties.

The rule that had been established back in November of 1987 clearly exceeded a reasonable level of policing activities on the part of the IRS or on the part of the IRS expectations of the savings institutions. Frankly, we want to cooperate with the IRS, but we don't think we should be coerced into using heavy-handed methods to enforce IRS regulations.

And so we are hoping that the hearing today can lead to changes in the punitive penalties that result currently.

In 1983, when this legislation first went into effect, the savings industry estimated that the initial one-time withholding compliance startup cost would be something in the neighborhood of a half billion dollars and that the annual cost to the industry would probably be in the neighborhood of $300 million. That appears to be roughly correct in that it appears that about $2 billion has been spent to date by the industry in ensuring compliance.

I think with all the information we have been hearing lately about FSLIC and some of the other problems facing the industry, we can readily see that that $2 billion could have been put to good use in maintaining the capital position of the industry.

These ongoing compliance costs continue to drain profits from the institution and, then, thereby undermine the industry's capital position.

We would like to see, No. 1, that the IRS consider all of the facts. I think this had been touched on previously, but I would like to reemphasize it. That all of the facts be looked at when deciding whether or not a compliance penalty should be imposed, and again the issue of proportionality should be addressed.

We think that the IRS should consider all of the factors when they assess a fine. An example, if the institution used the IRS computer tapes to identify incorrect pre-1984 TINs and then subsequently requested certified W-9s from these account holders, it's our view that that institution did exercise due compliance or due diligence in carrying out its activities.

Yet, the IRS apparently believes that that is not sufficient to meet their requirements and can penalize you for it. As you can well imagine, with the cost of postage rising, annual mailings are expensive. Yet, a current IRS regulation requires that if a person who had an account with our institution pre-1984 did not file a TIN number with us as a result of one of our mailings, we must continue to mail a letter to that person into perpetuity. The law does not provide for us to change that process. It seems to us that that's unreasonable.

If someone, since 1984, hasn't sent it in, the likelihood of him doing it this year, next year or the year after is pretty remote. It might make sense to have one more mailing, although I'm not sure what purpose would be served by that, and then end that process and either institute back up withholding, allow us to drop that account, or some other mechanism to eliminate it from this whole process.

In addition, savings institutions receive B notices, which you have already heard about, produced from the TIN matching program that lists invalid and missing TIN accounts.

It seems to us that, by sending the B notices to the savings institution and, in turn, causing us to use a somewhat heavy handed approach with our customers to make sure that we are in compliance with the IRS regulations, does not really serve the ultimate purpose that we are trying to achieve, which is tax compliance.

It would seem to me that it would make sense for the IRS, which has a lot more information about that individual than we do in most cases, should mail that notice to the customer directly. If they have his taxpayer number, if they have his address, all of those thing, it seems to me why don't they mail it to him rather than having the savings institution mail it to him.

It seems to me that if the IRS contacts those customers or those depositors directly, we are going to find that the errors are going to be corrected much faster than they would in a process where you have a chain from the IRS to the savings institution out to the customer, back to the institution, and back to IRS. And, of course, problems can enter in anywhere in that process.

Another example of the sort of seeming unreasonableness of the process. For example, if a woman uses her married name and Social Security number when opening an account, but hasn't changed her name with the Social Security Administration, it triggers a whole series of processes that could result in penalties for a savings institution.

It seems to us we have no way of knowing that that instance has occurred where she has gotten married prior to opening the account, nor should we know that. That is none of our business. And yet the process can impose fairly heavy penalties on the institution in terms of applying that process.

Well, on the topic of returns, we would like to provide the IRS with a suggestion that we believe that would improve the quality and efficiency of the reporting system, both for us and both for the IRS if B notices will still be mailed by the institutions.

When the IRS furnishes its B notices to savings institutions, window transactions with incorrect TINs and a waiting TIN account without TINs will be listed even though due diligence was exercised. Moreover, a $50 penalty will be excessed for each account unless the institution signs a certification letter, stating it has exercised due diligence for these returns. Before certifying, of course, we have to follow an entire process to make sure that we have fully complied with all of the regulations that apply.

Only after this analysis can an institution clearly certify that the missing TIN was for an awaiting TIN account that may have happened several months previously. It seems to us that the IRS could put into their tapes a separate field that would identify those TIN awaiting accounts so that when it comes through, it is not treated as an absent TIN and create an entire compliance process.

At TCF where I work, for example, we open somewhere between 10,000 and 20,000 new accounts every month. I don't know what our error rate is. I don't even know precisely what the number of TIN awaiting numbers are. But, nevertheless, you can see with the kind of numbers that are involved, the added complexity to this process because of the procedures that the IRS has provided is an unnecessary and costly process.

We hope the committee can be a catalyst for change in making sure that the backup withholding, TIN compliance, and information reporting regulations are doing what all of us wanted them to do, and yet can be done in an orderly and an effective—and I don't believe they have to be done in a heavy-handed manner.

We understand the IRS objective is to improve the quality of information reporting, and to minimize underreported interest income.

I think we all support those objectives. However, the IRS has been overzealous in the enforcement procedures demanded of savings institutions and others. We would like the IRS to look at all of the facts when determining whether due diligence has been exercised.

We'd like to see the elimination of the annual mailing requirement to free 1984 account holders without certified TINs, and the authority to close those accounts with missing or obviously incorrect TINs.

Another change we'd like to see is the elimination of fines in excess of $100,000. We think they ought to be capped at that level, rather than open-ended as they are today.

Particularly for information returns submitted late, inappropriately, or with invalid TINs.

And finally, we'd like to see the IRS send its B notices directly to the taxpayer. And one point that wasn't in my prepared testimony but I'd like to add to the suggestions that we think ought to be considered. Currently you have a zero tolerance system, meaning that if a person earns one cent of interest in a year, it triggers an entire series of activities ultimately to backup withholding, if necessary, to make sure that the IRS gets their income.

It seems to me that an account balance threshold would go a long way to ease some of the problems associated with this. As an example, if we have a $200 account balance at an average interest rate of let's say 7 percent that would earn $14 in a year.

If you were to withhold at 20 percent rate that amounts to $2.80. The fact is, it costs us more than $2.80 to withhold that money and send it on to the IRS.

That seems to me to be unreasonable. It would seem that there's no reason why we couldn't establish a threshold at which the benefits to the IRS, to the U.S. Government, and to the institutions that are working so hard to comply with these laws, aren't all brought together to achieve the best results.

Thank you, Mr. Chairman.

[The statement of Mr. Fischer follows:]

TESTIMONY OF HANK FISCHER
TCF BANKING AND SAVINGS, F.A.

BEFORE THE SUBCOMMITTEE ON OVERSIGHT
HOUSE COMMITTEE ON WAYS AND MEANS

JULY 28, 1988

My name is Hank Fischer, Vice President and Director of Public Affairs of TCF Banking and Savings, Minneapolis, Minnesota, with $6 billion in assets. Joining me is Tom Thomas, Vice President of Operations at the U.S. League of Savings Institutions. We are both here to testify on behalf of the U.S. League of Savings Institutions on information return reporting, which is a matter of vital interest to savings institutions. We support the Internal Revenue Service's war on taxpayers that intentionally underreport or fail to report reportable income. However, if the war is to be won, the IRS must use the means within its arsenal instead of transferring the bulk of the enforcement efforts onto savings institutions.

It is our goal to provide this subcommittee with facts that will encourage it to modify statutes so the IRS can scale back the excessive policing activities and punitive assessment of fines and penalties that exist in the TIN compliance and information reporting regulations.

We want to begin on a favorable note before we substantiate opposition to certain oppressive provisions in the backup withholding, TIN and information reporting regulations. We are gratified that some progress has been made to correct provisions that undermine our industry's support of these regulations. For example, IRS Notice 87-71 authorized prospective administrative relief from penalties under Section 6676(b) for payers that inadvertently failed to make the due diligence TIN compliance mailings. More recently, IRS Notice 88-77 eliminated the November 23, 1987 TIN compliance rule that forced savings institutions to either close awaiting-TIN accounts opened in 1988 without certified TINs or incur penalties. The November rule clearly exceeded a reasonable level of policing activities that the IRS can expect from savings institutions. Savings institutions are willing to cooperate with the IRS, but we should not be coerced into using heavy-handed methods to enforce IRS regulations.

We are hopeful that many more of the conditions leading to punitive penalties can be changed as a result of this hearing.

In 1983, the U.S. League estimated that the initial one-time withholding compliance start-up and implementation costs would approach $1/2 billion for savings institutions. Moreover, yearly ongoing administrative and monitoring costs would exceed $300 million annually. So far, $2 billion has been spent to comply with the IRS withholding and TIN reporting regulations. Surely, you will agree that this is quite substantial. This financial burden has hurt the profits of the savings institution industry. Ongoing compliance costs continue to drain profits needed to maintain and strengthen the industry's capital position.

Thus, first of all, we would like to see the IRS consider all the facts when determining whether savings institutions exercised due diligence under the temporary backup withholding regulations (T.D. 7916, 7922 and 7929). Currently, IRS discounts any conscientious efforts pursued to obtain correct account holder TINs other than the prescribed mailings in the regulations. Such a narrow application of the rule means savings institutions have been assessed penalties and fines which in some cases have exceeded one million dollars despite no willful neglect or intentional disregard of the regulations.

We believe that the IRS should consider other factors when assessing fines. For instance, if an institution used the IRS' computer tapes to identify incorrect pre-1984 TINs and then subsequently requested certified W-9s from these account holders, it, in our opinion, exercised due diligence and no fines should be assessed for not making the prescribed mailings. Consequently, where circumstances demonstrate a conscientious commitment to comply, savings institutions should not be fined and their penalty appeals should be granted.

Another backup withholding requirement needs revision. For pre-1984 accounts that have not furnished certified TINs, savings institutions are forced to make an annual W-9 mailing until a certified TIN is received. Unfortunately, failure to make an annual mailing means due diligence has no longer been exercised and an institution is subject to possible fines. Perpetuity mailings must be stopped! If account holders have not responded in five years to a TIN mailing, it's unlikely they will do so in the future.

Annual mailings are expensive, too. Besides the postage and mailing expense, there is considerable staff time to track uncertified TIN accounts, computer software, storage and transaction costs, and many other expenses.

We must remember that these pre-1984 accounts were opened before the TIN regulations became effective in 1983. To us, five mailings demonstrate that savings institutions certainly met the spirit of the regulation. We believe regulations should be revised in 1988 to require only one more annual mailing for pre-1984 accounts. Moreover, it seems unproductive to require an annual mailing if the IRS has not identified the TIN as invalid in a "B" notice.

Annually, savings institutions receive "B" notices produced from the IRS' TIN-matching program that lists invalid and missing TIN accounts. In turn, institutions must mail a notice to these account holders and try to resolve the discrepancy. By sending "B" notices to savings institutions, the industry bears the brunt of the IRS' enforcement and TIN policing efforts. We question why these notices are being sent to savings institutions and not directly to the taxpayer.

In our opinion, the IRS should make the mailings to taxpayers and be responsible for resolving TIN errors. Savings institutions have a responsibility to obtain a TIN but not police its accuracy for the IRS. We recommend that the IRS should follow the procedures outlined for underreporters in IRS Regulation 35a.3406-2(f). This rule requires the IRS to mail multiple notices to taxpayers over a period of time before notifying payers that their account holder is subject to backup withholding.

Likewise, incorrect TIN notices should be mailed directly to the taxpayer by the IRS. Corrected TINs furnished to the IRS by taxpayers should be sent to financial institutions. For unresolved cases, the IRS should send a notice to the financial institution to impose backup withholding. In short, the IRS should be the front line of defense and responsible for controlling and maintaining the accuracy of the TINs it identified as incorrect. IRS duties should be performed by the IRS, not savings institutions.

By having the IRS make direct contact with taxpayers over TIN discrepancies, errors are corrected faster. In particular, marital name changes are reflected sooner and, in cases where the taxpayer TIN is correct but the IRS records show it as wrong, the IRS records will be updated faster. Mailing invalid TIN notices to taxpayers alleviates the unfair penalty imposed under the rule specified in Question and Answer No. 69, contained in the November 23, 1987, backup withholding regulations. When a woman uses her married name and Social Security number when opening an account but has not changed her name with the Social Security Administration, the TIN will be identified as invalid. Under the November rule, the savings institution will be fined for submitting an incorrect TIN. Savings institutions are not in a position to control what name or Social Security number customers use. This current rule is certainly an unfair imposition on savings institutions.

We would now like to comment on the harsh and unyielding penalties that can be levied for incorrect TINs, untimely filing or filing returns on an inappropriate media. Penalties for failure to file on a timely basis or on the appropriate magnetic media for most filers is limited to a maximum fine of $100,000 under IRC Section 6011(e). Not so for financial institutions. No maximum fine exists when filing returns late or improperly. Also, the fine for filing late is the same for not filing at all. Clearly, these penalties are excessive and do not reflect levels of noncompliance. Likewise, under IRC Section 6676, the IRS is not restricted in levying a maximum fine for incorrect TINs for interest and dividend reporting. Here, again, the penalty is severe. Maximum fine provisions should be added to the Internal Revenue Code.

While on the topic of returns, we would like to provide the IRS with a suggestion that would improve the quality and efficiency of the reporting system for us and for the IRS if "B" notices will still be mailed by payers. When the IRS furnishes its "B" notices to savings institutions, window transactions with incorrect TINs and awaiting-TIN accounts without TINs will be listed even though due diligence was exercised. Moreover, a $50 penalty will be assessed for each account unless the institution signs a certification letter stating it has exercised due diligence for these returns. Before certifying, however, savings institutions have to scrutinize the missing TIN list, research each item listed and ascertain whether due diligence was exercised. Only after this analysis can an institution clearly certify that the missing TIN was for an awaiting-TIN account or for a window transaction. This analysis is costly and time-consuming. We recommend that the IRS seriously consider adding a new field to its magnetic media reporting formats. Such a field would enable the IRS to identify these returns and exclude them from its "B" notice lists. Dropping these items from the listing eliminates a needless reporting, tracking and verification burden for the IRS and savings institutions.

In conclusion, we ask that this subcommittee be the catalyst to foster change in the backup withholding, TIN compliance and information reporting regulations. We understand that the IRS' objective is to improve the quality of information reporting and minimize underreported interest income. We support these objectives; however, the IRS has been too overzealous in the enforcement procedures demanded of savings institutions and others. We certainly would like the IRS to look at additional facts when determining whether due diligence has been exercised. We also would like to see the elimination of the annual mailing requirement to pre-1984 account holders without certified TINs, and the authority to close these accounts with missing or obviously incorrect TINs. Another change we would like to see is the elimination of fines in excess of $100,000 for information returns submitted late, inappropriately or with invalid TINs. And finally, we would like to see the IRS initially send its "B" notices directly to taxpayers and not require savings institutions to bear the brunt of the IRS' TIN policing duties.

We appreciate this opportunity to discuss this issue of great concern to savings institutions. We look forward to your questions.

Chairman PICKLE. Thank you, Mr. Fischer. I want to ask a question at this point. Mr. Walker, we'll hear you in just a second.

I've got to go to a luncheon. I noticed, Mr. Scrobola, that you had pointed out in your testimony that your firm spends a great deal of money just issuing these information reports. And for you and for all businesses, it's a terribly expensive procedure.

We don't know how else to handle it, but we recognize it's expensive.

I understand, though, that your firm, Merrill Lynch, had issued 1099's at the first of the year, this February. And then you reissued them in late March or in April.

They were recalculated to show different figures with respect to dividends, capital gains, and other aspects of it.

Now, they were issued then after many taxpayers had already filed their returns. So my first question is, did that practice take place with Merrill Lynch?

Mr. SCROBOLA. Yes, in answer to your question, we did issue what we call an amended 1099 consolidated tax reporting statements. But what I think you're talking about is, we provide an additional service to our clients where we provide them with information on municipal bonds, and we do not report that information to the Internal Revenue Service. It's not required.

Now, what we did is, when we reported initially in January, we left off the coupon issues, and merely reported the registered issues.

So to provide the service we should provide, we went back and we reran the statements to include all the municipal——

Chairman PICKLE. Then the amended 1099's that were mailed were mailed primarily with respect to figures based on municipal bond sales in that area?

Mr. SCROBOLA. Yes, sir.

Chairman PICKLE. They were not 1099's in general, but only with respect to municipal securities?

Mr. SCROBOLA. The major portion of them, right.

Chairman PICKLE. So you didn't send all new 1099's out?

Mr. SCROBOLA. No, we sent out a consolidated statement. We sent out over 4 million of them that contained approximately 18 million 1099's.

So I think our error factor was something less than half a million 1099's.

Chairman PICKLE. Did all of the taxpayers who filed prior to this recalculation have to file an amended return?

Mr. SCROBOLA. If they relied on that, yes, they probably would.

Chairman PICKLE. They would naturally rely on it. They get a mailing from you and it says—they're not going to sit and just say, oh, I'll keep this quiet until next year.

Mr. SCROBOLA. Of course not. But again, we were addressing municipal interests which is not reportable from the broker's standpoint, and merely provided it as an additional service.

The individual has their own 12-month statement to provide that info.

Chairman PICKLE. Well, why couldn't you—or could you? I'm not trying to be critical. Why couldn't you get that information out say by February 1 instead of waiting until late March or April, which is the closing time?

Mr. **Scrobola**. You have to bear in mind, we have a very narrow window in which to process this information. Our files that contain the reportable information contain 116 million records.

In order to compile those files and get them ready to print statements, we work up until January 15. Now that gives us actually 15 days to generate these 4 million statements. That's print them, fold them, mail them and get them out to the public.

So if an error is discovered after the 15th of January, there's no way possible we could stop the process.

Chairman **Pickle**. Now, I would ask the same question of the S&L's. I have a feeling this is a common practice. Is the issuance of corrected 1099's a practice of S&L's and banks?

Mr. **Fischer**. I'm going to have to ask one of the staff people from the savings league. Because I have not experienced it in our institution.

I think as the point was made, though, there was some distinction between the first and the second 1099.

Chairman **Pickle**. Mr. Scrobola says his was with respect to municipal bond sales, but yet the mailing that we have here dealt with gross dividends and distribution of stock and capital gain, not with respect to municipal bonds per se.

Mr. **Scrobola**. Sir, what I said was, the mass mailing that we did in the early part of the year was for the municipal bonds.

But if an individual comes into me, or into Merrill Lynch, and says, points out a fact that we had an error in our system, we will go back, correct the 1099, and also correct the tape to the IRS to ensure both the taxpayer and the IRS have the same information; that is correct information.

Chairman **Pickle**. It just seems to me that where impossible—yes, Mr. Fischer.

Mr. **Fischer**. Mr. Chairman, my impression is that's generally a one-shot deal. Partly we don't deal with the wide variety of transactions that some other institutions might have.

Chairman **Pickle**. I think you would all recognize that the taxpayer, when he first files his return, he wants to make it complete, and it wants to make it accurate.

And his intent is to comply with the law. Part of that would be from any outside income that would be shown through a 1099.

Now, if he doesn't get that information from you, the S&Ls and the banks until after April, then it's too late, in effect, without him then having to file an amended return. That should not be done.

And I'm just saying to you that in principle, as a rule, we ought to try to get these things out. And that includes municipal bonds and anything else.

Now, if you have evidence, new evidence, all you do is file an amended return. But I'm just saying the intent ought to be to get those out earlier, certainly by February 1.

Is there any disagreement with anybody on the panel about that?

Mr. **Scrobola**. None, but if I may, Mr. Chairman, there are regulations that are recently been issued, actually issued in March of 1988, addressing REMICs, which are real estate mortgage investment conduits.

They are retroactive to 1987. And the regulations provide that a chain of nominee reporting that will force, if you have a trustee sending Merrill Lynch a 1099 on a REMIC, I in turn will receive that some time in February, and the information is not available any other way except through that 1099, I have 30 days in which to send that information out to the taxpayer.

Which brings me up to March 2. If we are acting on behalf of another broker, I will send that information to the second broke, who has some time until April to send that information out to the taxpayer.

And the regulations actually force people to file late, just by that chain of nominees.

Chairman **Pickle**. I wanted to ask that question at this point. Let's proceed then with the testimony. Mr. Walker, and then Mr. Flippo will ask any other questions.

STATEMENT OF DOUGLAS WALKER, REGIONAL DIRECTOR, NATIONAL SOCIETY OF TAX PROFESSIONALS

Mr. **Walker**. Thank you, Mr. Chairman.

I am Douglas Walker, chairman of the National Certification Board for Tax Professionals, and I am representing the National Society of Tax Professionals as the regional director.

It is our belief that the necessity for penalty provisions in our tax system is well understood and accepted by taxpayers and by tax professionals who assist taxpayers for hire.

Concern is now being expressed by some, however, that a policy that has always assumed a high degree of honesty and integrity may be evolving into one premised on a belief that taxpayers and tax professionals are inherently careless or dishonest, and that compliance can best be achieved through a policy of fear and intimidation.

We believe the most important factors in ensuring a high degree of compliance are trust, and mutual respect. These qualities cannot be promoted by penalties or policies that are perceived to be unfair or excessive.

The mistake of the Internal Revenue Service—the Internal Revenue Service task will certainly not be made easier, let me put it that way, when these essential ingredients are missing in their enforcement efforts.

Particularly ominous is the number and severity of new penalties plus excessive increases in the amounts of the existing penalties.

All coming at a time when tax laws are undergoing unprecedented change, and taxpayers are increasingly confused about the requirements of these new laws.

This can only have a detrimental effect on the Government's overall effort to increase taxpayer compliance. There are many who feel threatened, and some express fear, of violating laws that they do not understand, or might not even know exist.

And this problem is really exacerbated by an avalanche of new and complicated of information reporting requirements, many of which we've heard about already today.

Taxpayers correctly feel that they are being forced to rely upon the judgment and integrity of tax professionals, even though there are no nationally recognized standards, licensing requirements, or way to judge the relative competency of these tax professionals at this time.

At the same time, tax professionals themselves are forced to cope with ever-changing laws, rules, and regulations that are often ambiguous, or poorly written, poorly defined, and that sometimes require judgmental decisions which, if wrong, however honest or however sincere will trigger heavy penalties.

It is inevitable that innocent parties will, in some instances, be hurt or even destroyed financially by the new rules.

While there must be effective laws to deal with dishonest or lawless individuals, and with careless or reckless individuals, such laws, to be effective, must also provide for the protection of the innocent.

The same principle holds true for the penalty provisions of the Internal Revenue Code. They must allow for honest errors, or inadvertent omissions.

Some of the newer penalties make no such allowance, and in fact, appear to be aimed at preventing errors and omissions, rather than at cheating.

This represents, we believe, a major shift in the philosophy underlying the concept of compliance penalties. And this is of great concern to tax professionals who understand this shift.

The automatic equating of an error to negligence with the taxpayer or tax professional having to prove otherwise amounts to what can best be termed an infallibility policy. It has ominous implications for both the taxpayer and the tax professional.

An example of this shift is the penalty for failure to report on one's tax return any taxable amount shown on an information return.

This penalty, which is 5 percent of the underpayment attributable to the underreported amount, was expanded by the Tax Reform Act of 1986.

Negligence is presumed in the absence of clear and convincing evidence to the contrary. It is difficult to understand why the U.S. Treasury or the Congress felt that this penalty was necessary.

Consider the following. First, the IRS has already been notified of the payment and to whom it was paid.

Second, the IRS computers easily match this information with that reported by the payee on his or her tax return.

Third, notice of any discrepancy is automatically sent to the taxpayer.

What opportunity does this leave for cheating? Who is foolish enough to deliberately fail to report income on his or her tax return with the full knowledge that it's already been reported to the IRS by a third party?

On the other hand, an honest omission is likely at sometime to occur. Information reports arise from payors over a period of months. One is apt to be misplaced or overlooked.

Carelessness, perhaps. But is it of such a nature that should warrant an automatic still penalty? How does one go about establishing, quote, clear and convincing evidence that a penalty should not be assessed?

The IRS has given some examples of how a presumption of negligence in this case may be rebutted. Four examples are:

First, the information return prepared by the payor is in error.

Second, the taxpayer did not receive the information return.

Third, underreporting was caused by death or illness of the taxpayer, and the information was simply not available to the preparer.

Fourth, the taxpayer receives erroneous information from an IRS employee.

The absence of any reference to honest errors or inadvertent omissions by the taxpayer makes it clear that there will be no tolerance for these.

It's been referred to already today as the zero tolerance level. With the burden of proof falling on the taxpayer, it will be virtually impossible to defend against this kind of penalty.

For instance, how does one prove that an information return has not been received, or that an IRS employee has provided erroneous information?

There are no reciprocal arrangements to compensate the taxpayer and the tax professional for time and cost incurred as a result of IRS errors, omissions, and erroneous assessments.

The cost to taxpayers for responding to IRS errors is enormous. This fact can be substantiated by consulting any competent tax accounting firm.

While it is recognized that there are taxpayers who do cheat on their taxes, it should also be recognized that the overwhelming majority of taxpayers are honest, and should not be penalized to make up for revenue lost to tax cheaters.

It should also be recognized, we believe, that many taxpayers overpay their taxes due to ignorance, due to mistakes in reporting, or in some cases, fear of being challenged for taking even legitimate deductions.

With all the publicity that the loss of revenue, the cheating or the carelessness, why is the issue never raised about the overpayment of tax?

It is not inconceivable to think that one might offset the other.

Thank you.

[The statement of Mr. Walker follows:]

NATIONAL SOCIETY OF TAX PROFESSIONALS
P.O. Box 2575, Vancouver, WA 98668

Testimony to be given by the National Society of Tax Professionals (NSTP) before the Subcommittee on Oversight, Committee on Ways and Means.

Comments on IRS Penalties

The necessity of penalty provisions in our tax system is well understood and accepted by taxpayers and by tax professionals who assist taxpayers for hire. Concern is now being expressed by some, however, that a policy that has always assumed a high degree of honesty and integrity may be evolving into one premised upon a belief that taxpayers and tax professionals are inherently careless or dishonest and that compliance can best be achieved through a policy of fear and intimidation.

We believe the most important factor in assuring a high degree of compliance is trust and mutual respect. These qualities cannot be promoted by penalties or policies that are perceived to be unfair or excessive. The IRS's task will certainly not be made easier when these essential ingredients are missing.

Particularly ominous is the number and severity of new penalties plus excessive increases in the amounts of existing penalties---all at a time when tax laws are undergoing unprecedented change and taxpayers are increasingly confused about the requirements of these new laws. This can only have a detrimental effect on the government's overall effort to increase taxpayer compliance. There are many who feel threatened and some express fear of violating laws that they do not understand or might not even know exists. This problem is exacerbated by an avalanche of new and complicated information reporting requirements. Taxpayers correctly feel that they are being forced to rely upon the judgement and integrity of tax professionals, even though there are no nationally recognized standards, licensing requirements or way to judge the relative competency of such individuals. At the same time, tax professionals are forced to cope with ever changing laws, rules, and regulations that are often ambiguous or poorly defined and that sometimes require judgmental decisions which, if wrong (however honest and sincere), will trigger heavy penalties. It is inevitable that innocent parties will, in some instances, be hurt or even destroyed financially by the new rules.

While there must be effective laws to deal with dishonest or lawless individuals and with careless or reckless individuals, such laws, to be effective, must also provide for the protection of the innocent. The same principle holds true for the penalty provisions of the tax code. They must allow for honest errors or inadvertent omissions. Some of the newer penalties make no such allowance and, in fact, appear to be aimed at preventing errors or omissions rather than at cheating. This represents, we believe, a major shift in the philosophy underlying the concept of compliance penalties, and is of great concern to tax professionals who understand this shift.

The automatic equating of an error to negligence, with the taxpayer or tax professional having to prove otherwise, amounts to what can best be termed an "Infallibility Policy". It has ominous implications for both the taxpayer and the tax professional.

An example of this shift is the penalty for failure to report on one's tax return any taxable amount shown on an information return. This penalty (5% of the underpayment attributable to the unreported amount) was expanded by the Tax Reform Act of '86. Negligence is presumed in the absence of "clear and convincing evidence" to the contrary. It is difficult to understand why Treasury or Congress felt that this penalty was necessary.

Consider:

- The IRS has already been notified of the payment and to whom it was paid.
- The IRS computers easily match this information with that reported by the payee on his or her tax return.
- Notice of any discrepancy is automatically sent to the taxpayer.

What opportunity does this leave for cheating? Who is foolish enough to deliberately fail to report income on his or her tax return with the full knowledge that it has already been reported to the IRS by a third party. On the other hand, an honest omission is likely, at sometime, to occur. Information reports arrive from payers over a period of months. One is apt to be misplaced or overlooked. Carelessness? Perhaps. But is it of such nature that it should warrant an automatic stiff penalty? How does one go about establishing "clear and convincing evidence" that a penalty should not be assessed?

The IRS has given some examples of how a presumption of negligence in this case may be rebutted. Examples include:

- The information return prepared by the payer is in error.
- The taxpayer did not receive the information return.
- Under-reporting was caused by death or illness of the taxpayer and the information was not available to the preparer.
- The taxpayer receives erroneous information from an IRS employee.

The absence of any reference to honest errors or inadvertent omissions by the taxpayer makes it clear that there will be no tolerance for these! With the burden of proof falling upon the taxpayer, it will be virtually impossible to defend against this kind of penalty. For instance, how does one prove that an information return has not been received or that an IRS employee has provided erroneous information?

There are no reciprocal arrangements to compensate the taxpayer and the tax professional for time and cost incurred as a result of IRS errors, omissions and erroneous assessments. The cost to taxpayers for responding to IRS errors is enormous! This fact can be substantiated by consulting any average tax accounting firm.

While it is recognized that there are taxpayers who cheat on their taxes, it should also be recognized that the overwhelming majority of taxpayers are honest and should not be penalized to make up for revenue lost to cheaters. It should also be recognized that many taxpayers overpay their taxes due to ignorance, mistakes in reporting, or in some cases, fear of being challenged for taking even legitimate deductions. With all the publicity about the loss of revenue to cheating or carelessness, why is the issue never raised about the overpayment of tax. It is not inconceivable to think that the one might offset the other!

Mr. FLIPPO [presiding]. Thank you, Mr. Walker.

Mr. Stephenson.

STATEMENT OF NELSON L. STEPHENSON, SENIOR EXECUTIVE VICE PRESIDENT AND CHIEF FINANCIAL OFFICER, EAST RIVER SAVINGS BANK, NEW ROCHELLE, NY, ON BEHALF OF THE NATIONAL COUNCIL OF SAVINGS INSTITUTIONS

Mr. STEPHENSON. Thank you. I would like to commend the subcommittee on their patience in these proceedings, and I will try to make my remarks brief.

There have been a lot of remarks this morning with respect to these issues, and our testimony is included in our written materials, so I'll summarize quickly.

My name is Nelson Stephenson. I'm senior executive vice president and chief financial officer of East River Savings Bank in New Rochelle, NY. I represent the National Council of Savings Institutions, with members who have assets that exceed $550 billion.

I would also like my remarks to be remembered as being very practical this morning. I think there are a series of points I'd like to make and then summarize.

The first is that our industry has, at substantial cost, achieved what I think is a substantial compliance with the intentions of the law that this committee helped to create.

It's also correct to say that our industry supports the goal of full tax compliance, and we are effectively in a position now to be able to claim at our institutions that we have substantially full compliance with the reporting of tax identification numbers.

We also support the requirement that whenever a taxpayer has failed to properly indicate his tax identification number, we should immediately begin backup withholding to ensure that the proper revenue collections are made.

Our concern with the regulations really stems from the fact that we don't believe the method of the original promulgation of the regulations allowed sufficient input by the industry or time for practical implementation. We really think that needs to be corrected with an almost immediate move on the part of the IRS to work with the industry groups that we represent to develop more practical representations of the intentions of the committee.

We also believe that the imposition of a $50 penalty per count, which is cumulative and annual, is a very severe penalty in a situation where the industry, and many practitioners, have tried very very hard to comply with this law. As an example, in our institution, after a considerable amount of work which had to be done on a very quick turnaround basis, we had 3,600 accounts which were not in a position to be able to certify.

Some quick calculations: it gives rise to $180,000 penalty. And I will assure you that that's substantially greater than what was expected.

We also are not certain that those are not errors. We have no way to prove that the IRS wasn't in error in that calculation.

We think that's representative of many, many institutions who are receiving these error notifications in substantial numbers.

We also believe that the IRS has not been responsive in the appeals process. I know in our case, our discussions with the IRS have been very, very fruitless. I do not want to criticize individuals particularly, but I know that it is very, very common in comments that come back through our committee at the National Council that the IRS' agents in the field and the people who are responsible for resolving these cases are not trained adequately.

The appeals process is not well defined, and I will tell you, from a practical perspective, it's not working.

I think in summary and in conclusion, what we'd like to propose is really two things. We'd like to encourage that reasonable regulations be finalized and implemented, to accomplish the intent of the statute.

And second, we would like to suggest that payors who have a problem with their process are entitled to reasonable and timely due process. They should not be put in a situation where they're held in limbo for 2 or 3 years trying to resolve a situation which even the Service is not sure how to resolve.

We really do think that it's time for the IRS to work with our industry to come up with practical regulations which are both cost-effective and meet the intent of the law.

I'll be glad to answer your questions.

[The statement of Mr. Stephenson follows:]

COMMITTEE ON WAYS & MEANS
SUBCOMMITTEE ON OVERSIGHT
UNITED STATES HOUSE OF REPRESENTATIVES

Statement of Nelson Stephenson
on behalf of the
National Council of Savings Institutions

on

Civil Penalties Provisions of
The Internal Revenue Code of 1986

July 28, 1988

Introduction

My name is Nelson Stephenson, Senior Executive Vice President and Chief Financial Officer of the East River Savings Bank of New Rochelle, New York with $2.7 billion in assets as of June 30, 1988. I am here to testify on behalf of the National Council of Savings Institutions (the "Council") on a matter of great concern to our members. The Council represents savings banks and savings and loan associations nationwide with assets of over $550 billion. I want to ask the Subcommittee on Oversight to take whatever measures are necessary to help reduce the severity of the temporary regulations implementing the backup withholding laws. The regulations provide for the imposition of harsh penalties on payors of interest and dividends who fail to use the requisite standard of diligence in ensuring the accuracy of taxpayer identification numbers ("TIN"s) on certain accounts. Specifically, I urge the members of this Subcommittee to ask the Commissioner of the Internal Revenue Service (the "Service") to set up a meeting with payor groups to discuss the problems and to release proposed regulations for public comment as soon as possible.

Congress passed the withholding and penalty provisions of the Interest and Dividends Tax Compliance Act of 1983, as amended by the Tax Reform Act of 1986, (the "Act") in order to increase reporting and compliance by payors of interest and dividends. Prior to the change in law, it was believed that the penalties for failure to supply correct TINs was being frustrated because the standard of conduct imposed on payors of interest and dividends was too liberal. In order to aid the Treasury Department's effort in matching the receipt of interest and dividends with individual taxpayers Congress sought to encourage increased compliance from payors by making the consequences of a failure to comply more costly while increasing the payors' burden to show that the standards of compliance had been met.

While we understand and have assisted in Congress' efforts to increase compliance through TIN matching programs and backup withholding, we feel that the procedure, as it now exists, needs to be changed. Under the Act, payors of interest and dividends who do not exercise due diligence are subject to a $50 penalty for filing an information return with an incorrect or missing TIN. In 1984, the Service began assessing penalties against payors for incorrect or missing TINs unless specific compliance with the Act's due diligence requirements could be proven. In 1986, the Service began to issue penalty notices for noncompliance with the information reporting requirements of the Act. In theory, the procedure seems to be a reasonable one. In practice, however, the regulations as promulgated by the Service impose extraordinary burdens on payors which make compliance difficult. This results in oppressive and pointless penalties on taxpayers who are making a good faith effort to comply with the law and regulations.

Discussion

Adoption of the Regulations

The Regulations interpreting the Act were released at the end of 1983, and amended several times, most recently in November, 1987. At all times, the Regulations have been in so-called "temporary" form. The Administrative Procedure Act states, however, that regulations may be promulgated in temporary form only when "notice and public procedure thereon are impracticable, unnecessary or contrary to the public interest." While this definition gives the Service a great deal of latitude, to have provided for a public comment period, however brief, would have been neither impractical nor unnecessary and certainly not against public interest. In fact, many of the difficulties associated with the regulations, which have become increasingly apparent, could have been avoided had these regulations been proposed for comment.

Without a reasonable public comment period, the Service has little ability to understand the mechanics of, and limitations on, a payor's ability to comply with the mandate of the regulations. As previously mentioned, some of the regulations are extremely difficult, if not impossible to comply with. Furthermore the costs associated with the Service's proposals are often substantial and do not reflect the inherent reality that not all payor institutions are similarly situated so as to be able to meet the administrative and financial burdens imposed by the regulations. Without a chance to review and comment on regulations which so overwhelmingly impact on financial institutions, payors are left unprepared to implement adequately these regulations which take on the characteristic of a heavy-handed fiat, rather than a practical, governing procedure.

The result is a set of regulations which are at times inconsistent, impractical, incomplete and unable to accomplish the Act's ends because they do not address adequately nor place the onus on the source of the noncompliance. Chief among the examples of inconsistency and incompleteness is the issue of the "incorrect TIN." Section 6676(b) of the Internal Revenue Code of 1986 (the "Code" or "Code") imposes a penalty only when the TIN supplied is incorrect. Code section 6109(d) requires the social security number issued to an individual to be used as the identifying number of that individual. Logically and realistically, then, a TIN is an "incorrect TIN" if it is not the number that was issued to that person by the Social Security Administration (or other appropriate governmental agency). Regulation sections 35a.3406-1(a)(6) and 35a.9999-3, Q/A 69, however, take the position that a TIN is incorrect if it is a number issued to a particular individual under a different name. This situation tends to occur when woman marries and takes her husband's name but does not change her Social Security Number. The inequities of this situation are apparent when it is realized that as a consequence of a payee having an incorrect name, a payor may be subjected to a $50 penalty. Moreover, the cost of such a penalty cannot be recovered from the customer.

The Service sends its incorrect TIN notices out annually; thus, quite often, some payors receive several thousand notices at once. Given such volume and considering the instances in which the notices may not immediately reach the appropriate individual at the payor institution, it seems inequitable to impose such penalties on an institution for what very often only amounts to an innocent name change. For example, Regulation section 35a.3406-1(c)(2) requires that within 5 business days after receipt of the Service notice, a payor must notify a customer of the incorrectness of the TIN provided and that backup withholding will begin in 30 days unless the situation is otherwise resolved. Furthermore, the date on the notice (which is post dated) is deemed to be the date of receipt. Moreover, in the change-of-name situation, the individual is very often reporting the income in question, so the Service is no worse off. Fairness would tend to indicate that as most name changes are not for the purposes of avoiding taxes, responsibility for compliance is more appropriately borne by the payee and not the payor.

Administration of the Regulations

Not only are the regulations intrinsically unfair, but the Service's administration of them present an additional host of inequities for payors of interest and dividends. As the regulations are ambiguous and the penalties they prescribe are dissimilar and often contradictory, compliance is often difficult if not impossible. Furthermore, the structure of the regulations and nuances on which imposition of the liabilities hinge are so confusing even the Service personnel have difficulty with their interpretation, let alone with effective, even handed enforcement.

The penalties are vast in number and dissimilar in effect. Whether a particular penalty applies depends in part on the nature of the infraction and the existence of intent. At a minimum the determination of whether intent exists requires some sort of analysis, which may differ depending on the reviewer. This, in turn, has a distinct and incontrovertible bearing upon the execution of the enforcement which becomes disparate and controversial.

Likewise, the appeals procedure for addressing penalties imposed under section 3406 of the Code needs review. Officials at the IRS National Office have indicated that each District office is delegated the responsibility for collecting the penalties and implementing the appeals procedure for the institutions in its district. While it was anticipated that such a structure would assist in expediting the appeals process, it has instead led to differing interpretations of the applicable Code sections and regulations by the various District offices. When contradictions do arise, it is very difficult, if not impossible, to reach a Service representative at the National Office who can provide clarification of these issues.

What is still more confusing and incomprehensible, as well as excessively punitive, is the "due diligence" standard established by the Service. The diligence considerations were originally amended back in 1983 in order to encourage greater compliance among payors in supplying TINs with respect to interest and dividends by imposing a higher standard of conduct in complying with the obligations. It should be stated that the financial services industry had, for years, reported TINs to the Service. Under the regulations, unless the due diligence requirements are satisfied, a $50 penalty is imposed on a payor for any account if the payor fails to furnish a TIN on a Form 1099-INT or 1099-DIV for that account.

While this procedure seems, prima facie simple, in fact it is not. The due diligence standards are too strict. The Service's apparent aim is to impose a zero error rate on payors, a standard which, practically, is impossible for the financial service industry to achieve. There is too much emphasis placed on the failure of the industry to conform to specific steps, rather than focusing on a desired result, diligence and a general level of compliance, for example. The common goal should be compliance; as long as an institution completes all the steps outlined in the due diligence safe harbor analysis, the order in which the steps were taken should be irrelevant. Moreover, there are no available alternatives to the current due diligence standard; fairness would seem to indicate that options should be provided before onerous penalties are imposed.

While the concept of imposing certain responsibilities on payors seems theoretically tenable, in practice the regulations take on an impervious effect. For example, in order to exercise due diligence for pre-1984 accounts, the regulations require payors to undertake an annual mailing to the addressees of accounts with incorrect or no TINs. The effect of an annual mailing delinquency is cumulative, however, so that if the payor fails to make a mailing in one year but satisfies the obligation in subsequent years, the payor is still liable for the section 6676(b) penalty not only with respect to the delinquent year but each subsequent year regardless of whether mailings are undertaken in subsequent years. While the Service recently finally provided authority for a "make up" mailing, completion of such a mailing only provides relief on a prospective basis.

Impact on the Thrift Industry

Unfortunately many of the inequities and punitive aspects of the regulations have their most decisive impact on savings banks and savings and loans. The mandates imposed by the regulations are costly and time consuming for all of thrift industry let alone the smaller, and especially those experiencing financial difficulties. Most noticeable in this regard are the limitations on financial resources, computer capability, staff availability and time. Section 35a.3406-1(c)(2) of the regulations, for example, requires a payor to notify a customer that the Service has determined that the TIN given by that customer is incorrect, and that backup withholding is to begin in 30 days unless the situation is corrected, within 5 business days after the payor has received the Service's notice. The date on the notice is deemed to be the date of receipt. As noted earlier, the Service notices sent to financial institutions are not always addressed (and therefore delivered) to the appropriate department or person; this is an especially acute problem where in a smaller institution a defined compliance department or person may not even exist. Several days may elapse before the person responsible for compliance with "B Notice" procedures even receives the notice.

Furthermore, many institutions receive many more than a manageable amount of notices at any one time. For instance, in 1984, my institution participated in a Service tape matching program submitting 315,470 individual account records for matching. We were advised by the Service that 16,568 of the numbers submitted were potentially incorrect. As a result 16,568 W-9 forms and letters had to be mailed to those potentially delinquent account holders. While the facts of the tape matching program are not entirely analogous to the scenarios which have developed since then, the numbers provide an understanding of the outrageous obligations which may be imposed on institutions within a 5 business day period.

The regulations also require payors to backup withhold on all reportable payments to any account of the payee that contains the incorrect TIN. Implicit in this regulation is the misconception that a financial institution's various relationships with a particular customer are all contained on a single computer system. A substantial portion of financial institutions do not maintain a centralized customer relationship file within their computer systems. Thus to determine whether a particular customer has other relationships with the financial institution necessarily requires the institution to make several searches through separate computer systems. Manual searches are not a viable option given the 5 business day time constraint.

Of significant consequence for any financial institution is the requirement that payors maintain records and monitor which payees receive two incorrect TIN notices in a three year period. The Service anticipates that where a payor determines that a payee has received two incorrect TIN notices within the three year period it will notify the payee, begin to backup withhold and refuse any future certification from the payee. Cessation of the withholding may be done only with the Service's approval.

We believe that it is entirely the Service's responsibility to monitor and determine the number of notices that have been sent to payors of specific payees. The Service seems to understand this since its principal reasons for imposing this obligation on the payors are the difficulties for its computer system to store this vast amount of information and the fear that it cannot adequately monitor the notices sent to payees because there may be different accounts involved or there may be different TINs involved. The concerns are certainly legitimate ones, and in fact are shared by all financial industries alike. Further, we are especially concerned that these costs will have a detrimental affect on smaller institutions.

Most troubling is the effect many of the penalties have on the business decisions and practices of the industry. A growing number of thrifts are simply refusing to open accounts for individuals who do not have a TIN at the time they come in to begin the banking relationship. These well-meaning organizations are having to turn away legitimate business customers because they do not appreciate many of the regulations' nuances, and cannot afford the penalties if they misinterpret stated procedures and fear having to keep abreast of all the continuous changes lest they be subjected to a rash of exorbitant penalties. Furthermore, many savings institutions are having their community goodwill destroyed and are consequently losing business because they are having to impose backup withholding on accounts that have been in existence for 20 years or more which have correct but uncertified TINs. Most often, the customer does not understand the need for certification, and later becomes more confused as well as disgruntled upon learning that backup withholding has been imposed on certain amounts in the account.

Legislative History and Intent

Congress, in 1983, sought to increase compliance with the TIN reporting requirements by increasing the responsibility of payors as well as the consequences of noncompliance to both the payor and the payee. We believe, however, that the harsh burdens and uncertainty imposed on the financial industry by the Service through the temporary regulations goes beyond even the Congressional intent.

The system of enforcement and penalties which the Service has housed in its temporary regulations does not accomplish Congressional objectives. In 1983, Congress was not only concerned that repeal of the withholding provisions would contribute to a fall-off of revenue but also feared that its repeal would encourage noncompliance while appearing to honest taxpayers that the system was not working fairly. In that year, the issue was whether or not to extend withholding to interest and dividend income, not whether and how much payors or interest and dividends should be scrutinized and penalized.

A commonly shared concern was that the alternatives to withholding would entail a greater government intrusion into private affairs. Moreover there was concern that the increased level of audit and penalty imposition required by stronger enforcement would be burdensome for many taxpayers and information reporters. Backup withholding, as a compromise, would accomplish two ends: it would increase compliance on behalf of delinquent accounts while minimizing the intrusion into the routine affairs of taxpayers and financial institutions. The penalties approved by Congress in that year were likewise in compromise fashion. Since there was not going to be an across-the-board withholding imposed on all accounts, some mechanism was needed for encouraging payors to comply with the spirit of the initiative. It seems, therefore, that while Congress intended that there exist some consequence for a failure to be diligent, it was never intended that the Service be empowered to hinder the financial industry with confusing regulations, conflicting responsibilities and exacting penalties.

In point of fact, the unintended has been the result. The regulations promulgated by the Service have been an intrusion since their release with an inadequate comment period. The scope and interpretation of certain defined terms exceeds that contemplated by Congress in the statutes. Furthermore, the excessive, harsh penalties do not accomplish Congress' objective to increase revenue by increasing compliance. If, in fact, Congress intended to provide the Service with the ability to adopt such strict regulations, then I believe it should reconsider some of the issues presented in light of the affect the regulations are having on financial payors as well as the effectiveness present procedure has had on increasing compliance and revenue.

Conclusion

Between August and December of 1983, the Service made a concerted effort to work with representatives of the financial industry in an effort to adopt workable regulations. In spite of the time pressure involved in promulgating complicated regulations in such a short period of time, the Service seemed willing to try to incorporate the concerns of the financial services community into the regulations. Sometime after December, 1983, the working relationship that had been established disappeared. Not only were industry concerns not incorporated into the Service's activities, but phone calls and other inquiries on important and legitimate concerns were not even returned or otherwise given a response. Furthermore, the appeals process has likewise been ineffective in resolving these cases.

The Savings and Loan and Savings Bank industries, like the rest of the financial industry, have made both a financial and operational commitment to working with Congress and the Service with an end toward improving compliance in reporting interest and dividend income. We applaud and share your goal of increased revenues through means other than increased taxes. Our grievance is quite simple: we need reasonable rules concerning backup withholding; we need defined standards of expected conduct; we need to have an opportunity to voice not only our concerns but the realities of the proposals and the limitations on our respective abilities to comply with their mandate.

I must stress again, that our industry has invested substantial sums of money in order to comply with Congress' wish for increased reporting and withholding. Our actions with regard to due diligence unquestionably indicate a willingness to comply, to cooperate. But cooperation is also required from the Service and we need for Congress to send a message that it also wishes to see some cooperation. While I have already outlined many of the industry frustrations and grievances throughout this testimony, I am attaching a list which condenses many of the aspects of the regulations which concern the savings industry.

Mr. Chairman, we appreciate the opportunity to present our views on the state of the temporary regulations on backup withholding on payments of interest and dividends. I cannot stress enough that we are committed to cooperating with Congress and the Service to increase compliance in the area of TIN accuracy and income reporting. We do believe, however, that the present circumstances are not equitable and do not appreciate the financial industry's efforts to improve our operational capabilities to comply with these regulations. We therefore urge the Subcommittee to take the necessary steps to remedy an unfair situation and ensure that the aim of increased compliance is not frustrated.

Below is a list of matters we feel merit further attention by the Internal Revenue Service:

-The name change issue; when a woman marries and assumes her husband's name, whether that constitutes an incorrect TIN, or should.

-The effective date of the new backup withholding notice procedure.

-The problem of jumbled notices.

-The problem of the obligation of B notices coinciding with the end of most financial institutions' business year. (Information reporting requires that it be undertaken at the end of the calendar year.)

-Ambiguity concerning the due diligence required for new accounts.

-Inability of financial institutions to establish procedures for dealing with the present penalty system.

-The requirement that payors keep track of the number of incorrect TIN notices individual payees receive.

-The impact which mergers and acquisitions have on the due diligence requirement.

-The timing of the clarification rules which were released in June.

-Magnetic media problems and other software inconsistencies.

-Window transactions.

-The ineffectiveness of the appeals process.

Mr. **Flippo**. Thank you very much, all of you, for your testimony.

Mr. Allen, I think an intriguing concept that you introduced, that you would be willing to hold to the same standards of error in handling your business that the IRS is; is that essentially what your proposal is?

Mr. **Allen**. Yes, sir, and we wouldn't even ask for the 50-percent rate that the GAO cited as the erroneous IRS taxpayer advice ratio.

Mr. **Flippo**. And you wouldn't even want that necessarily in the statute.

Mr. **Allen**. We could live with something less than 50 percent.

Mr. **Flippo**. You'd live with a floating figure, is that right, whatever their figure is?

Mr. **Allen**. We could live with less than 50 percent.

Mr. **Flippo**. Sounds like a reasonable proposal to me.

We've had testimony that there are occasions when an individual deposits, or a company makes deposits for tax purposes, and that the financial institution has erred in making that untimely.

Are you aware of any instances of that? Could you tell us what the magnitude of that problem might be?

Mr. **Allen**. I'm not aware of the instances. I'm aware of where that came from. I believe that was in a consultant's survey result submitted with the Small Business Administration testimony.

Let me just say that the likelihood of a misdirected deposit of taxes by a bank customer has the same approximate probability as the misprocessing of a check or a deposit to that customer's account.

As to whether banks are holding the funds on a float basis, which I believe was indicated in that survey, I just cannot believe that that is occurring. When you make the deposit of taxes, there is a date stamp that is put on the coupon itself, and that, for all practical purposes, controls whether or not that deposit is late, even if the bank should fail to remit that deposit to the Federal Reserve Bank.

But that date of receipt controls the timeliness relative to the depositing taxpayer.

Mr. **Flippo**. If that should happen, Mr. Allen, does a businessman have any recourse against the bank in the event that takes place?

Mr. **Allen**. Well, certainly mistakes occur. And I know in my own particular institution that we have made, where there has been a misrouting of a deposit and we are at fault, restitution to our customer.

That is more apt to occur, I believe, on a mailed in deposit, because it's not designated to go to the proper area in the bank for processing, than it is with someone walking in off the street to make that deposit.

[The following was subsequently received:]

AMERICAN
BANKERS
ASSOCIATION

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TAX COUNSEL
Henry Ruempler
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August 18, 1988

Rep. J.J. Pickle, Chairman
Subcommittee on Oversight
Committee on Ways and Means
U.S. House of Representatives
Washington D.C. 20515

Dear Mr. Chairman:

The purpose of this letter is to elaborate more fully on our response to the questions raised at the hearing by Reps. Schulze and Flippo concerning timely filing by commercial banks of payroll taxes collected by small businesses. The basis for the questions appeared to be an unsupported assertion in the survey attached to the testimony of the witness from the Small Business Administration. This Brown Associates survey report states on page 23, "A few of the respondents blamed the banks for not crediting their payments immediately in order to get interest-free use of the funds. We have no information as to whether there is any validity to this claim." Brown Associates goes on to say that the IRS has the information to determine if the banks are using "float time" and the responsibility to stop the practice if it occurs.

The American Bankers Association witness, Jonathan Allen, testified that he was not aware of such occurences, especially in light of the procedure for accepting the deposit of payroll taxes and other such funds. As described in the Treasury Dept. regulations, 31 CFR 214, every payment of payroll taxes deposited by an employer at a commercial bank accepting Federal tax deposits, whether in person or by mail, must include a date stamped on the Federal tax deposit form, which serves as the basis for determining the timeliness of the payment. Thus, the depositor is entitled to a receipt at the time of the deposit which confirms the timeliness of the payment for IRS purposes and cuts short the possibility of any IRS penalty on the depositor regardless of when the bank actually transmits the funds to the Federal Reserve district bank. Indeed, if the bank fails to timely remit the funds to the Federal Reserve bank, there is a penalty directly on the bank which is determined by a rate of interest set by the Treasury Dept. under 31 CFR 203.10 (b)(1)(ii).

The role of commercial banks in the Federal tax deposit system is carefully defined by the regulations, requiring application by the financial institution for permission to serve as a depository, procedures for daily transmittal of the funds with identifying information and a prohibition against charging the customer for the paper work (Treasury pays a flat fee of 50 cents per item). The Financial Management Service in the Treasury Dept. started an evaluation of the program last year. If there are any instances of banks using float on Federal tax deposits, that evaluation could address the issue.

We hope this information puts to rest the vague and unsubstantiated assertion about "float" which surfaced at the hearing. If the Subcommittee would like additional information on this subject, please feel free to contact me at 663-5317.

Respectfully submitted,

Henry Kuempler

Mr. **Flippo**. Thank you.

Mr. Scrobola, I guess I was left unclear as to the normal practice. In the absence of rapid changes in tax law and deposit law and that sort of thing, is it not the normal process to have one mailing to the client a year, on a timely basis, and in time for him to file his return?

Mr. **Scrobola**. Yes, sir, it is our normal practice to have them all out by January 31.

Mr. **Flippo**. In the instance that we were talking about, instead of it being mutual fund filing as opposed to——

Mr. **Scrobola**. In the mutual funds area, there were some changes made in the 1986 act that required reporting of income that was not actually received.

Mr. **Flippo**. So that necessitated——

Mr. **Scrobola**. That's right, a lot of the mutual funds had the ability to announce a record date for a dividend up to 12 midnight on December 31. That would not be picked up until early January in the Standard & Poor's or other publication.

Mr. **Flippo**. You do not anticipate a reoccurrence of that event taking place again, unless Congress changes this law again.

Mr. Fischer, let me ask for a little further clarification on an area that you mentioned, where an individual may get married, change their name.

Would you elaborate on what that—that sounds——

Mr. **Fisher**. Well, essentially, a customer might come into the institution, open an account, give us their name, let's say Jane Doe as an example, or Mrs. John Doe, whatever the case may be.

And we accept the information. She gives us a Social Security number for the TIN that is submitted to the IRS, and at the end of the year, the IRS pops that back to us, and says that this number doesn't match Miss Jane Doe; it matches Jane Merriweather, or whatever name. They don't tell us that, of course. They just say it doesn't match.

We then have to go back through an entire process. We don't know that she was married just before she opened the account. Actually she could have been married for quite some time.

Because the fact is that people don't think about these things, that they have to notify Social Security and so on.

Nevertheless, the IRS doesn't take that process into account in the way they've established these rules and regulations. As a result, we have to carry the burden of attempting to clarify that.

It seems to us that they could, as part of the earlier suggestion we made, which is to deal directly with the taxpayer, solve that problem much faster than we can.

I don't think it's fair to expect us to know that somebody was recently married, or any of those other personal things about them.

Mr. **Flippo**. Well, it looks like we're either going to have to find some solution to this or stop all this marrying, one or the other.

I guess we've all heard about the terrible complexity in this system. I don't suppose that withholding on interests and dividends, that any of you would suggest would be a viable alternative to this complexity, would you?

Let me say that I think that what I hear from all of you is that most of these problems could have been dealt with probably much better, and avoided if we had a good deal more exchange between perhaps the IRS and the people who are required to do the reporting, to work out each other's problems.

And I suppose that we would want to encourage that for the future, to the largest extent possible.

I think you've made some very good suggestions, and pointed out some areas that need to be changed, both legislatively but primarily administratively, I believe.

And so we'll be looking forward to working with you to bring about some of those changes. And thank you very much for your testimony today.

The next panel—I think perhaps in the interest of time we would like to ask all of those who are remaining to testify to join us at the table at this time. We have the National Association of Manufacturers with Paul Huard; National Federation of Independent Business, Abraham Schneier; David Burton, Howard Moss; the Association of Private Pension and Welfare Plans, Mr. Uslander; and Chester Salkind, executive director of the American Society of Pension Actuaries.

Why do we not start with our vice president of taxation and fiscal policy? Paul, would you please start our testimony today?

STATEMENT OF PAUL R. HUARD, VICE PRESIDENT, TAXATION AND FISCAL POLICY DEPARTMENT, NATIONAL ASSOCIATION OF MANUFACTURERS

Mr. HUARD. I appreciate this opportunity to present our views on behalf of NAM's 13,000 members. In the interest of time, I will try to make an abbreviated summary of my remarks.

Mr. FLIPPO. That would be most appreciated. Thank you.

Mr. HUARD. The recent trend of tax legislation has been to make the Federal tax laws more and more complex, to the point where the ability of both taxpayers and the IRS to properly understand and apply the law is clearly in question. At the same time, however, pressures of the Federal budget deficit have led to an ever-increasing reliance on the penalty provisions of the tax laws as a means of raising substantial Government revenue.

NAM believes that the current reliance and emphasis on penalties, particularly as a revenue source, is misplaced and that the existing penalty structure is poorly and haphazardly designed. In our view, tax penalties should fulfill, and be limited to, the role of inducing compliance and ensuring that those who choose deliberately to disregard the rules for filing returns and for computing and paying the proper amount of tax are punished for failing to participate in this burden of citizenship.

It is unfair to go beyond this and to use the penalty system, as it is presently being used, to raise substantial amounts of revenue from taxpayers who are making good faith efforts to comply with an exceedingly complex and confusing law. This unfairness is particularly evident where penalties are applied to those portions of a deficiency that do not arise from the conduct that is sought to be penalized.

NAM recommends, therefore, that the existing penalty structure, which is replete with overlapping and pyramiding provisions, be replaced with a single consolidated penalty provision that precisely and understandably identifies all the specific situations which Congress believes warrant the imposition of a penalty. Such situations should be clearly classified and categorized.

Deliberate offenses should, in our view, be heavily penalized, and much more heavily penalized than careless performance. Innocent mistakes should not be penalized at all. Furthermore, in no event should penalties be applied to amounts of a deficiency that are not a result of the penalized activity or position.

In conclusion, NAM believes the penalty provisions of the code should be designed to ensure that everyone fairly complies with the law and pays the Government the taxes that are due. They should not be designed to trap the unwary taxpayer, nor utilized as a permanent source of growing revenue for the Government. The latter function should be accomplished only through the substantive provisions of the code.

Thank you.

[The statement of Mr. Huard follows:]

TESTIMONY ON
CIVIL PENALTY PROVISIONS
CONTAINED IN THE INTERNAL REVENUE CODE

BY
PAUL R. HUARD
VICE PRESIDENT, TAXATION AND FISCAL POLICY DEPARTMENT
NATIONAL ASSOCIATION OF MANUFACTURERS

BEFORE THE
SUBCOMMITTEE ON OVERSIGHT OF THE
COMMITTEE ON WAYS AND MEANS
U. S. HOUSE OF REPRESENTATIVES

JULY 28, 1988

Thank you, Mr. Chairman. I am pleased to be here this morning to present the Association's views on the civil penalty provisions contained in the Internal Revenue Code.

Recent legislative enactments have included base broadeners that have been highly complex. These present incredible problems for individuals and small businesses. However, implementation of these provisions will be very difficult even for taxpayers having significant in-house compliance capability. The Internal Revenue Service (IRS) is reflecting these complexities in its inability to respond accurately to taxpayers' questions as well as in its public pronouncements about interpretative functions it must perform, such as the issuance of regulations.

The same legislative enactments that have embodied more complex provisions have also included provisions for raising additional revenues through increased compliance and penalties. Given the budget problems of the federal government, and the need to find novel approaches that at least appear to meet revenue targets, it has become popular to assume that increased compliance and penalties can generate significant amounts of revenue.

This simultaneous increase in both complexity and penalty provisions presents an awesome and fearsome regime for taxpayers to manage. Taxpayers are overwhelmed by the complexity of the new laws, and are not fully certain that they can comply with all the requirements of these laws. This should not surprise us since the IRS by its actions has shown that it cannot tell us what the law means in some fairly simple cases. Corporate taxpayers face problems far beyond issues the IRS cannot handle, because their issues are so complex.

The existing tax laws have over 125 penalty provisions. These are not neatly catalogued, and many lay as traps for the unwary that become obvious only after the year's results become known and taxpayers find the events of the year have led to unexpected results. An excellent example of this problem is the underpayment penalties for estimated taxes that depend on the taxpayer's ability to forecast earnings in advance.

All of this causes us to inquire: what is the purpose of a penalty under the Internal Revenue Code? Presumably, the penalty is there to insure that the provisions of the law are adhered to with reasonable care. In other words, penalties should bring about a better level of compliance, both in terms of reporting income and deductions properly and in terms of paying the taxes due promptly. Their purpose should be to deter inappropriate behavior and not to raise revenue.

Unfortunately, Congress has chosen over the years to use penalties to encourage certain behaviors, such as making certain distributions from qualified trusts or benefit plans. I suggest it would be better to give the organizations a longer term target to meet and demand that performance as a requirement for tax preferred status. Similarly, there have been attempts to use the revenue laws as a way to attack non-revenue problems, such as the requirement of gambling stamps and firearm transfer taxes, which are aimed more at curbing the activity than raising revenue. Burdening the IRS with these non-revenue tasks deflects them from their goal as an agency designed to raise the necessary revenue for the operation of government.

Another problem is that today's tax laws are overrun with situations where Treasury and the IRS have a license to write the law after the statutory provision has been enacted. This means that the operative provisions of the law are determined by technocrats who have no elected position. They are inclined to adopt rules that are particularly complicated and have a consistent pro-government and pro-revenue bias.

Several recent provisions reflect this bias, particularly the elimination of the practical capacity method of inventory accounting and the attempt to change the export sourcing rules. Neither of these changes is supported by the statute or legislative history. In particular, the new inventory rules are exceedingly complex to apply. The Treasury's operative rule seems to be that no regulation is too complex because its provisions can be managed by computers.

This reasoning is wrong, and leads to provisions that, because they are unadministrable, are likely to lead to some form of non-compliance. That, in turn, is likely to present penalty situations for the taxpayers involved. We now have a set of tax laws that may well be compliance-proof. The implications of that, in terms of taxpayer attitudes about compliance, are not encouraging. If these compliance burdens are harnessed with penalties like Section 6661 for motive power, taxpayer morale is going to sink to very low levels indeed.

We are concerned that innocent mistakes will be punished with penalties and that good faith efforts to comply may not suffice to avoid being penalized. Comments by some senior IRS representatives lead us to believe that may well be what will happen. One District Director has publicly stated that all audit assessments should be accompanied by penalties under Section 6661, since the fact that the deficiency has been set up shows that the taxpayer did not have substantial authority for the position taken on the tax return. While this extreme position does not yet seem to be the operating standard followed throughout the IRS at this time, many of us in the profession hear rumblings that indicate the National Office policy may be headed in this direction.

Penalties have become more severe both in terms of threshold of applicability and in raw amount. An example of the former is the Section 6661 penalty, ostensibly placed in the law to discourage taxpayers from taking unwarranted positions in their returns on the chance that such positions will not be detected unless the return is audited and the further chance that they may slide through even then. While tax planning based on this so-called "audit roulette" technique may have been useful for taxpayers whose returns are not always audited, it simply is not a sound theory when applied to taxpayers included in the large case audit program. Those returns receive a careful examination by revenue agents for each and every year.

Taxpayers who are subject to this systematic audit cannot rely on lack of detection. If the item is of any consequence it will be examined and the item which has no support will almost certainly be detected. If a position taken by the taxpayer is truly abusive, the negligence penalty should be applied and should work. If the position is not negligent, but represents a difference in view between the taxpayer and the government about how the law should be interpreted, the government should not have the club of a 20% penalty for use in beating the taxpayer into submission. This is particularly so in the case of small taxpayers who may not be able to afford a defense against such jawboning.

It is almost impossible to put together a large return with no items not subject to adjustment, either through mistake or disagreement about how the law is properly applied. I have never heard of a large case audit that was closed with no adjustment to the taxpayer's return. I do not believe that this shows a general intent to deliberately not comply with the law. Most professionals responsible for return preparation for large corporations feel a responsibility to prepare the return in thorough compliance with the law. I would like to think that this is a matter of ethics. However, it is at worst a matter of common sense. If the return is to be carefully audited and the preparer knows this in advance, it makes no sense to deliberately do a poor job of preparation. This is particularly so when the disallowed item gives rise to interest charges on the tax deficiency. A market interest rate on tax deficiencies is probably one of the best and fairest ways to induce careful compliance.

Tightening the standards of compliance under which penalties are applied is another aspect of recent tax legislation that makes the penalty situation unreasonable. An example of this is the 90 percent standard applied to estimates of tax due. There is a perception that it is easy to estimate the earnings of a corporation early in its taxable year. Our experience belies that assumption. There are years in which the early estimates of income are grossly optimistic and other years in which later events produce unexpected income that only a Pollyanna would have predicted.

Holding estimates to a standard of 90% of tax liability along with the elimination, for large corporations, of the ability to use the prior year's liability as a "safe harbor" produces a situation in which the taxpayer very often will be forced to deposit with the government large sums of cash that may exceed its actual tax liability by many millions of dollars. The taxpayer's choice is to place the unwarranted amount in the Treasury or face the implicit fact of a disallowed interest charge by way of the penalty under Section 6655.

Returning to Section 6661, another aspect of that penalty is that it was initially intended as a "no-fault" penalty to be levied at a very low rate on audit adjustments. Philosophically, the concept of a "no-fault" penalty is abhorrent. Setting that matter aside, this provision has now evolved into a 20 percent penalty that can be levied on an innocent mistake by the taxpayer even if reasonable care has been exercised. This is a powerful weapon, and the likelihood of it being abused in individual cases is great. Obviously, if a taxpayer makes an outright mistake on a tax return there is going to be no substantial authority for the position, and if it is indeed a mistake the taxpayer cannot put a statement in the return that indicates there is no position in support of the item. If such occurrences are made the subject of large penalties, then taxpayers will rightfully resent the tax system even more than they do now.

Taxpayers' goodwill is essential to the success of the system. Yet revenue estimates in all recent tax bills have relied in part on additional collections from the imposition of penalties. The schedule of amounts to be collected in income tax penalties for the 1987 through 1991 period exceeded $2 billion and grew from less than $350 million annually to more than $483 million annually over that time span. It is inevitable that the IRS will feel pressure to increase the imposition of penalties to satisfy these projections. That is entirely the wrong direction to go.

Penalties should fulfill--and be limited to--the role of insuring that good compliance is the rule and that those who decide to live outside the rules for filing returns and paying taxes are properly punished for failing to fairly participate in this burden of citizenship. To go beyond this purpose, however, and to expect to raise substantial amounts of revenue through penalties imposed on those who are already doing their best to comply with this very arcane and complex system is both unfair and callous.

The present attitude of the IRS is to settle what the law is by legislation. Where it perceives taxpayers doing something that it judges to be inappropriate, then rather than litigate the issue and find out whether the taxpayer has properly interpreted the law, the Treasury comes up here for a legislative fix. The problem with that is the provisions grow ever more complex as a result. Also, those who may have been overly ambitious in their tax planning tend to be "grandfathered" in to the detriment of all other taxpayers.

Having registered a complaint, what do we offer? We believe the Internal Revenue Code should be revised to provide a single penalty section. The penalties provided therein should be concise and situations which Congress believes warrant penalties should be precisely identified. More specifically, the penalties should be classified first as to the offense, fraud, and negligence, and then categorized as failure to file or failure to pay.

Deliberate offenses should be more heavily penalized than careless performance, and innocent mistakes should not be penalized at all. Penalties on the latter only serve to teach the taxpayer that their government is inclined to be harsh and unfair. The percentage level for fraud and negligence penalties might, on the other hand, be reviewed for adequacy, and intermediate levels of imposition might be considered. In no event, however, should penalties apply to amounts that are not the result of the penalized activity or position.

Since the government now receives a higher than market rate interest on assessed deficiencies, there is no need to punish non-negligent errors (i.e., innocent mistakes) with penalties. In the past, when interest rates were fixed at 6% non-compounded, some taxpayers may have felt that borrowing from the government was cheap. That certainly is not a fair characterization of the situation today.

Among the things the penalty system should not do is be a defined revenue source, so that levying penalties becomes a game of "gotcha" played by the IRS against the taxpayers. It is also inappropriate to levy large penalties against non-compliance where there is evidence of good faith effort on behalf of the taxpayer to comply.

The penalty provisions of the Internal Revenue Code should be designed to insure that everyone fairly complies with the law and pays the government the taxes that are due. They should not be designed to trap the unwary taxpayer or as a permanent source of growing revenue for the government. The latter should be accomplished only through the substantive provisions of the Code and not through legerdemain in the penalties area.

Mr. **Flippo**. Thank you very much.
Mr. Schneier.

STATEMENT OF ABRAHAM SCHNEIER, LEGISLATIVE REPRESENTATIVE, NATIONAL FEDERATION OF INDEPENDENT BUSINESS

Mr. **Schneier**. Thank you, Mr. Chairman. My name is Abe Schneier. I would like to commend this committee for holding these hearings, and on behalf of NFIB, the National Federation of Independent Business, I thank you for the opportunity to appear before you today.

For many small business owners, life certainly has become a blur of complex new tax forms and new tax rules, as every year the IRS and many States continue to find ways to foster compliance. Somewhere between December 15 and January 15 of each year when a small business owner's accountant comes to call on him, he is beginning to really dread that visit because he knows that the accountant is going to bring some new piece of bad news or some new piece of compliance that he is going to have to deal with.

After the subcommittee announced that it was beginning an examination of IRS penalties, we did ask our members to provide us with some examples of problems that they were facing with the IRS. And I have to say that the bulk of the cases did come back citing problems with the payroll tax area. I did include several examples of those kinds of situations in our statement, in our testimony.

I would just like to relate one case in particular where a taxpayer received an IRS notice on a payroll tax issue informing him of an underpayment of 5 cents. He was assessed a combined penalty and interest of $318.99 on this deficiency. What was most disturbing to the taxpayer was that there was a form that the IRS included with this, a notice 746 which is attached to the penalty notice. And in that form it says, when a balance is less than $1 it is "our policy to disregard it." He was at a total loss for words as to why this penalty was being assessed of such an enormous amount.

Six months later a second event occurred when he received another notice of deficiency. However, in the intervening period he had had some records destroyed in a fire. The taxpayer requested additional documentation from the IRS. They did respond with a printout of deposits received. They matched the taxpayer's total completely. The taxpayer called back the service center and was informed that the penalty was in error and that it would be abated. No word comes except for 5 months later when his third notice arrives demanding penalty at the threat of liens and other threats to the taxpayer's business. At this point the taxpayer paid the tax.

This problem has been occurring in the payroll tax area particularly because 1980 was the last time the payroll tax thresholds were revised in the withholding area, and we have had some massive increases in payroll tax rates, as well as, in the wage base which is based for Social Security withholdings, has gone from somewhere around $27,000 to where it currently sits at $45,000. So the thresholds which were reasonable back in 1981 of $3,000 for when a small business must go from a monthly withholding to an eight monthly withholding system is much more strained at this point in time.

In addition, Congress has enacted changes in the tax laws which also put additional stress on the withholding areas. Changes such as additional requirements on fringe benefit reporting where additional items must be included in a W-2. Currently, the controversy over section 89 will result in some additional reporting requirements beginning in 1989 relative to amounts that must be included in income.

Clearly, the thresholds is something which should be addressed by the committee. I know that back in 1986 during the tax reform debate there was a proposal to increase the threshold from $3,000 to $5,000 of which the employer would have to go from a monthly to the eight monthly. It was rejected because of a revenue loss of about $1 billion over a 3-year period at that time.

Again, however, this was not as a result of any change in tax laws or any reduction in tax payments. It was simply due to a shift in payments, a timing shift, if you would, for when the Treasury would be collecting money. And we found that kind of interesting and upsetting, actually, for the small business owner.

I would like to comment, finally, on a point made earlier by Mr. Portney, which is basically that there is an army of unpaid, certainly penalized Internal Revenue agents out in the country, and it is the employer. Some 6 million employers are acting as collection agents for the IRS. And their mistakes, even when they are minor in nature, are penalized and in a very excessive manner. The analogy of the motor vehicle bureau where you are allowed at least a couple of minor errors before your license is taken away from you, I think is a very appropriate one. Certainly there needs to be some reforms in this area.

I would also like to mention in conclusion that, certainly the IRS has had its difficulties. There was recently a GAO study released which showed that the IRS was, in about 50 percent of its cases which were examined by the General Accounting Office, providing incomplete information to taxpayers. And that the period of time it took for a situation to be resolved often stretched on for months and months with correspondence passing somewhere in the night and with the taxpayer becoming frustrated because there is no one person at the IRS who can sit down, take a look at a terminal and actually come up with a resolution of a particular issue for them. No one can determine how much is deposited in their accounts, what is the deficiency, what is the problem.

I think that General Accounting Office study should be included in the record for this hearing as well as it was part of a Government Operations hearing.

I would be happy to answer any questions.

[The statement of Mr. Schneier follows:]

NFIB

National Federation of
Independent Business

STATEMENT OF
ABRAHAM SCHNEIER

LEGISLATIVE REPRESENTATIVE

NATIONAL FEDERATION OF INDEPENDENT BUSINESS

Before:	House Ways and Means Committee, Subcommittee on Oversight
Subject:	IRS Penalties
Date:	July 28, 1988

Mr. Chairman, on behalf of the more than half million small business owners who are members of the National Federation of Independent Business (NFIB), I am pleased to be appearing before you today to discuss the IRS penalties and the degree to which congressionally-enacted and IRS-imposed penalties are affecting small business.

Background

Taxes rank as the single most important problem to small business owners, according to the NFIB Quarterly Economic Report, and have held this priority position.

The reasons for this overwhelming concern are highly diverse. Constant juggling of the tax code by Congress in recent years has resulted in small business owners facing an annual nightmare of increased paperwork, unforeseen recordkeeping burdens, and ever increasing compliance costs, as accountants and attorneys must interpret and reinterpret the tax law changes. The burden of paying income taxes has begun to pale when compared to the burden of calculating income taxes.

Payroll taxes as a share of a small business owner's tax burden continue to increase at a dramatic rate, imposing substantial annual cost increases on labor. Over the last twenty years, Congress has increased payroll tax costs to the employer and the employee every single year.

It is now quite common for a small business owner to pay far more in payroll taxes than in income taxes. Compounding this increased cost is the increased burden of compliance, as more and more small firms are forced to make more frequent deposits of payroll taxes and as the Congress has altered the rules to require tighter and tighter estimates of liabilities.

Concurrent with the many legislative changes in the tax code, Congress has substantially increased the number of penalties which apply against taxpayers in different situations. Since 1982, Congress has imposed more than 150 new penalties on taxpayers and tightened up countless others.

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The Guardian of
Small Business

The IRS is increasingly in the unenviable position of being required to provide taxpayers with new guidance on the many different tax rule changes Congress enacts, to educate its own employees on the new law, and then to interpret the changes as tax returns are audited. I have a strong measure of respect for the job that the IRS has been given, and I recognize that a substantial percentage of all taxpayers have no problems with the IRS.

However, my sympathy becomes substantially mitigated as I receive reports on an ever-increasing basis from NFIB members about abusive and unresponsive treatment they have received at the hands of IRS employees.

Profile of NFIB Membership

The NFIB membership is as diverse as our national economy. The breakdown by industry is as follows:

INDUSTRY	PERCENTAGE OF NFIB MEMBERSHIP
Construction	15%
Manufacturing	12%
Transportation	3%
Wholesale	8%
Retail	31%
Agriculture	4%
Financial Services	8%
Non-Professional Services	13%
Professional Services	6%

* Per NFIB Quarterly Economic Report, April 1988

Half of all NFIB members have annual gross sales of less than $350,000, and 55% of all NFIB members have fewer than 5 employees. Clearly when we talk about the NFIB membership, we are talking about main street American businesses and typical business owners.

IRS Performance

Each year the Commissioner issues an annual report, and each report has a table which summarizes civil penalties assessed and abated. The following is a table which summarizes some data extrapolated from the Commissioner's reports for the years 1980, 1981, and 1985.

SUMMARY OF CIVIL PENALTIES ASSESSED AND ABATED

Type of Tax	Percentage of Abatements by Number of Cases			Percentage of Abatements by Dollars		
	1980	1981	1985	1980	1981	1985
Individual Tax	8.3%	8.6%	11.5%	12.8%	12.8%	24.8%
Corporate Tax	18.4%	19.7%	25.3%	53.5%	64%	72.8%
Employment Tax	10.9%	12.3%	30%	20.6%	25.4%	47.1%

For me this table is disturbing, especially when viewed in a time series. The IRS for some reason is abating ever- increasing percentages of penalties assessed against individuals, corporations, and all employers filing who pay employment taxes. I recognize the complexities which the IRS has had to adapt to over this time period, and I will leave it to the IRS to try to explain the reasons for this drop in efficiency. However, I firmly believe that a large part of the problem stems from inaccurate computer-generated notices from the service center and from inaccurate assesments made by IRS employees at these service centers.

I would hasten to say that these percentages are understated by a significant percentage, because a common practice by taxpayers and practitioners is to pay penalties under $500 without a fight. The reason that this occurs is that a tax practitioner must charge as much or more than the penalty in fees to fight a nominal assessment. Even if the taxpayer has his own staff working on the problem, the amount of wasted time precludes fighting nominal penalties in many cases.

Congressional Mandates

It seems that each year there is another effort at tax reform. Each of these efforts includes another major effort at increasing taxpayers' compliance. Since the passage of the Economic Recovery Tax Act of 1981, Congress has enacted somewhere in the range of 150 new taxpayer penalties.

Penalties may now be imposed on a taxpayer for reasons as diverse as:

* failure to file a form,
* failure to properly include a single piece of information on a form,
* failure to file a form in the correct format or media (i.e. paper or magnetic tape in some cases), and
* failure to tell the IRS that your treatment of an issue is one which is subject to some judicial interpetation.

Payroll Tax Penalties

However, the most difficult penalties for small business owners are those involving the timely depositing of payroll taxes. The level of concern has grown in direct proportion to the increase in the payroll taxes an employer must withhold and match.

The rules have become even more difficult because the federal tax laws require that an increasingly precise estimate of the liabilities be made and that deposits be made in a highly precise time frame.

Firms which once could depend on only having to make monthly deposits of payroll taxes are facing increasing payroll tax liabilities, and many are now in jeopardy of having to make deposits on an eight-per-month system of deposits. This eight-per-month system is a nightmare of paperwork for any small firm who is not using a computerized service.

Current law provides that if total quarterly withholdings do not exceed $3,000, the taxpayer can deposit monthly. However, go over the $3,000 threshhold once and you are penalized severely. This $3,000 level was set in 1980, before the substantial increase in payroll tax rates continued in the 1983 Social Security legislation.

Of concern as well is the necessity to make an estimate within 90% of the ultimate liability for both payroll taxes and estimated income taxes. A 10% error limit is very tight for a small business depending on adding machines and not computers.

Many small business owners cite these reduced thresholds for tolerance on payroll taxes and estimated income taxes as evidence that penalties are being used as revenue-raising sources and not simply to foster increased compliance with the tax laws.

As examples of how the penalty rules are affecting small business owners and the impersonal, irrational treatment that they receive from the IRS, I would like to provide the following NFIB member case studies:

Case #1

Case #1 illustrates a taxpayer's frustration with the IRS relative to a payroll tax assessment. While I am citing this particular case, let me say that this example is not an isolated example of this type of problem.

The taxpayer received an IRS notice informing him of a 5¢ underpayment of his 3rd quarter payroll taxes. He was assessed a combined penalty and interest charge of $318.99 for this deficiency. What was most disturbing to the taxpayer was that a notice 746, which was attached to the penalty, clearly states that when a balance is less than $1, " it is our policy to disregard it".

A second event occurred six months later when a final notice was due on a payroll tax deficiency. Having had some records destroyed a few months earlier, the taxpayer asked for additional documentation from taxpayer service. They responded with a printout of deposits received and the total. As they matched the taxpayer's total, he called back to the service center, and was informed that the penalty was an error and that it would be abated.

However, several months later a third notice arrived again, demanding payment for the same penalty. He gave up and paid it.

He states that the issue of the penalties is secondary to treatment by IRS personnel. He complains about the long periods of wasted time being put on hold and about the incomplete information provided verbally or in written form.

Case #2

This situation involves a past due notice received for underpayment of corporate income taxes. The first notice makes a claim for payment of $5,113 plus penalties. The taxpayer responded with a copy of his canceled check, showing timely payment being made (in fact, he overpaid). IRS responded with a notice stating receipt of the amended return.

Two months later a check arrived, refunding the full amount of the initial payment made, with a notice that an explanation would follow. Several months later a letter arrived explaining that the first check was misapplied and asking that the taxpayer return the check the IRS sent him. He issued a second check for the taxes due. One month later he received a penalty notice demanding payment, threatening fines and liens, when the whole issue was the fault of the IRS service center misapplying the funds to the wrong account.

Additional correspondence failed to address the point that it was the IRS's error in misappplying the funds and in refunding. A subsequent IRS letter stated that the reason for the interest is because the taxpayer, by cashing the check, had use of the funds for some period of time. Of course this fact was never mentioned to the taxpayer in earlier correspondence.

Case #3

This is another payroll tax case. The taxpayer received a notice informing him he may have paid his payroll taxes late. The taxpayer responds with a summary of payments indicating an overpayment from the previous quarter. A second notice arrives with a penalty assessment of $344.10, without any details as to how the penalty was calculated other than the usual coded form 746 which refers to code 03. Code 03 merely states the IRS's opinion that deposits were made late.

Subsequent taxpayer inquiries were answered so incompletely as to prevent the taxpayer from ever understanding what went wrong. It appears that the taxpayer crossed the line between having to make deposits on the eight-per-month basis rather than monthly, because monthly deposits exceeded $3,000.

Issues

In each of these cases and countless others we have received, the taxpayer must guess the reason for the deficiency, is not provided adequate information to determine the basis for the penalty or interest charge, and must guess as to how the penalty is calculated. The IRS notice in most cases is unresponsive, and by the time a second notice is dispatched, the threats begin.

The common thread in most of the letters received is that taxpayers feel the IRS is operating in a heavy-handed manner. Taxpayers are treated in a less-than-business-like manner and are fined excessively for inadvertent and occasional infractions of the rules. IRS communications are either incomplete, unresponsive to the questions asked, and usually simply ignore the taxpayer's questions.

Recommendations

Many IRS employees recognize the validity of the concerns taxpayers are raising over collection rules and procedures. We agree that part of the problem is one of available technology, part of the problem is managerial, and part of the problem is employee competency and training.

An IRS employee cannot give a proper response to a taxpayer unless he can see the taxpayer's account records. The IRS is upgrading its computerized facilities to provide technical staff with these capabilities so that accounts can be reconciled properly.

IRS employees must have a greater knowledge of the tax rules so that they can explain to the taxpayer reasons for assessments, or they must have the knowledge and authority to tell the taxpayer the IRS is wrong. It would also be helpful if through all stages of an IRS review, there would be one employee responsible for handling the case from start to finish.

IRS employees must be taught how to write letters in a manner which gets the point across but does not threaten or insult the intelligence of the taxpayer. How many of us in business would stand for a vendor taking the kind of attitude the IRS takes? Asking for 5¢ out of $40,000 is a waste of paper and employee time.

The penalties must be reviewed at all levels to determine if they are accomplishing their goals of fostering compliance with the tax laws. It is our contention that the payroll tax rules are most in need of attention by Congress.

Congressman Pickle, NFIB would be happy to work with you and the staff of the committee to identify some of the areas of concern to small business owners and to make specific recommendations for their reform.

0341T

Mr. FLIPPO. Thank you very much.

Mr. Burton.

STATEMENT OF DAVID R. BURTON, MANAGER, TAX POLICY CENTER, U.S. CHAMBER OF COMMERCE

Mr. BURTON. My name is David Burton and I am manager of the tax policy center of the U.S. Chamber of Commerce. Comprehensive penalty reform is long overdue. The approximately 150 penalties now in effect have eroded taxpayers trust in the voluntary tax system. A good example of how that can come about is two notices that we have attached to our testimony that I have gotten in the past couple months from our small business membership. One is an 8 cent underpayment of a payroll tax deposit which led to a $516.58 penalty. Another is a two-penny underpayment that led to a $400 payment. These are obviously extreme examples but it goes on on a very regular basis.

When you get hit with something like that I think your attitude towards the tax system does change a little bit. Imagine how we would all feel if we underpaid our VISA bill by a couple pennies and they sent us a late payment penalty of $500. I think it shows that we need some changes in the system. The system has become too complicated and in many instances downright unfair.

The American Bar Association earlier suggested a number of changes. They are very similar in form and framework to changes the chamber has supported for quite some time. I think perhaps some of their rates need to be examined in detail. But the basic structure of having conforming and non-overlapping penalties is sound.

I would like to discuss a number of specific penalties that we have concern about. One is the negligence penalty. It is structured in an entirely unreasonable manner. That is because the penalty can be imposed on the entire underpayment even though only a portion of the underpayment is attributable to negligence. In theory, and in practice in some cases, you can have an underpayment of $1 million and a negligent amount of only a few dollars and the negligence penalty would apply to the entire million dollar underpayment. That can obviously lead to manifestly unjust results.

We would support changing the penalty so that it applies only to the negligent underpayment.

We also favor outright repeal of the substantial understatement penalty. We believe, as does the ABA that the negligence penalty, if it is properly structured, can handle that. In the event that you all decide not to repeal the substantial understatement penalty, we would strongly urge you to clarify what constitutes substantial authority.

The substantial understatement penalty, by the way, is I think the most egregious example of penalties being used as an outright revenue raiser given the retroactive increase of it in 1987. Obviously, someone cannot change their behavior after the fact, and there clearly was no attempt by the Congress to use that as a deterrent. It was simply a revenue raiser.

We would support coordinating as many penalties as possible, in particular the negligence, substantial understatement, fraud, delinquency, and valuation penalties.

With respect to information reports that the financial institutions were talking an awful lot about, we think there is a lot of room for true simplification in this area by establishing a uniform penalty for all transaction-based reports. That way, you could take probably 40 different penalties off the books if you had one standard penalty. I picked 40 out of the air, but the true figure is an awful lot. It could be that many.

Similarly, it appears that most disclosure information reports could be integrated into a single penalty of a certain standard amount per failure. There are also ways of consolidating other information reports that businesses are now required to file.

Another area that is of great importance to our small business membership are the penalties imposed on payroll tax deposits, and both the notices that I have referred to earlier are payroll tax deposit penalties. The chamber has supported a number of the proposals that Abe talked about a minute ago to increase the threshold.

We also have developed a proposal that would adopt a different approach, namely if you have so many employees you would file twice a month. If you have more employees you file once a week. If you have very few employees you would file monthly. And you would know exactly what date you are going to file and it would be that simple and there is nothing else to it. We think you could structure that to have as much or as little revenue impact as you wanted to have. That would simplify the payroll tax deposit system a great deal and lead to, we think, a lot more compliance.

The final point I would like to make and I think will be discussed in the next panel is with respect to pension plans, whether it is a self-employment pension plan, a Keogh plan, or a qualified pension plan maintained by an employer. In many cases, some penalty other than outright disqualification is more appropriate. In many cases small businesses simply failed to go to their tax lawyer and get their plan updated in a given year after the changes in 1982 or 1984 and suddenly they find their plans disqualified. It would seem to us that somewhat less draconian penalties in that area are appropriate.

Thank you.

[The statement of Mr. Burton follows:]

STATEMENT
on
TAX PENALTY REFORM
before the
SUBCOMMITTEE ON OVERSIGHT
of the
HOUSE COMMITTEE ON WAYS AND MEANS
by
David R. Burton
July 28, 1988

Mr. Chairman and members of the Subcommittee, I thank you for the opportunity to present testimony on the tax penalty system. I commend you for holding hearings on this important subject and making penalty reform a major priority. I am David Burton, Manager, Tax Policy Center, U.S. Chamber of Commerce.

Comprehensive reform is long overdue. In the opinion of the members of the U.S. Chamber, the complexity, overlap, and unfairness of many of the approximately 150 penalties now in effect have eroded taxpayers' trust in the voluntary tax system and, as a result, have jeopardized the Internal Revenue Service's (IRS) ability to perform its collection function. The IRS notices attached to our testimony, in which two-cent and eight-cent underpayments led to $400 and $500 penalties, respectively, exemplify a system gone astray.

A reexamination of the role that penalties should play is essential. The U.S. Chamber understands that tax penalties are an appropriate vehicle to deter certain types of behavior and to ensure compliance with the tax laws. Penalties also allow the government to recover a certain amount of the administrative costs that it incurs from those who are in noncompliance. However, penalties that are perceived to be arbitrary, excessive, or unfair have a detrimental impact on voluntary tax compliance by promoting disrespect for the tax collection process.

There have been five major tax bills in this decade alone--the Economic Recovery Tax Act of 1981, the Tax Equity and Fiscal Responsibility Act of 1982, the Tax Reform Act of 1984, the Tax Reform Act of 1986, and the Revenue Act of 1987. These bills enacted many new penalties and raised the amounts of penalties, without thoroughly examining how the changes would interact with the existing penalty structure. This has resulted in a needlessly complicated penalty system, lacking internal coordination and understandable by only a few.

The American Bar Association (ABA) in its review of the civil penalty structure has suggested that certain percentages be established for distinct taxpayer penalties. The ABA Task Force recommends a 75 percent fraud penalty, a 50 percent intentional conduct penalty, a 25 percent negligence penalty, and repeal of the substantial understatement penalty or, if retained, a substantial understatement penalty no higher than 10 percent. The Task Force also recommends that the interest components to the negligence and fraud penalties, as well as the stacking of multiple penalties, be eliminated.

The U.S. Chamber recommends an approach similar to that proposed by the ABA, although the appropriateness of the rates deserves further study. Under such a framework, not only would the penalty structure be vastly simplified, but also a taxpayer would be assured that any penalty assessed would be proportional to his or her culpability. At this time, I would like to comment on several penalties that have been particularly burdensome to our members.

Negligence Penalty. Under present law, if any portion of a taxpayer's underpayment is due to negligence or a disregard of rules and regulations, that taxpayer could be subject to the negligence penalty under Internal Revenue Code (IRC) Section 6653(a). The penalty is equal to 5 percent of the *entire* underpayment, plus interest, even though only a portion of the underpayment may be attributable to negligence. This can lead to entirely unreasonable results. For example, if a taxpayer negligently underpays only $1 and the amount of the deficiency in question is $1,000,000, the negligence penalty would be applied to the $1,000,000. The magnitude of the penalty often will bear only a tenuous relationship with the magnitude of the infraction.

The harshness and need for statutory reform of this penalty are also illustrated in the recent *Asphalt Products Co.* case. In that 1986 case, the

Sixth Circuit Court of Appeals upheld the taxpayer's claim that the negligence penalty should not apply to the entire understatement where the penalty would have been many times the income negligently reported, on the grounds that such a result was "absurd." The Supreme Court, under the law as then written, reversed the Sixth Circuit. Clearly, this is an issue for statutory correction.

Such unreasonable results could be avoided if the negligence penalty were set at a higher rate but limited to the portion of the underpayment negligently reported. Simplicity could also be achieved if the interest-based portion of the penalty were eliminated. The ABA recommends that the negligence penalty have two rates applicable to different levels of misconduct. Under this approach, reckless or intentional conduct could be punishable at 50 percent, while negligent conduct could be punishable at 25 percent. The U.S. Chamber believes that this approach deserves serious consideration but the appropriateness of the rates deserves further study.

Substantial Understatement Penalty. Of major concern to the entire business community is the substantial understatement penalty under IRC Section 6661. A penalty equal to 25 percent of the understated tax applies if a taxpayer understates the tax liability by the greater of 10 percent of the correct tax owed or $5,000 for individual taxpayers or $10,000 for corporate taxpayers.

The substantial understatement penalty is a prime example of a penalty being used as a revenue raiser, which we believe is unsound tax policy. The Tax Reform Act of 1986 increased this penalty from 10 percent to 20 percent, prospectively only. The 1986 Budget Reconciliation Act increased the penalty another 5 percent to 25 percent and made it retroactive to open-year transactions for which such penalty had not yet been asserted. This raises serious issues as to when the penalty stops being a penalty designed to defer noncompliance and becomes, instead, simply a revenue raiser. If one of the functions of a penalty is to sanction undesirable behavior, it is impossible to justify a 150 percent retroactive increase for a "penalty" applying to behavior that took place three years earlier. Such a practice leads to inequitable consequences and arguably is unconstitutional as a violation of due process.

The operation of the substantial understatement penalty is unclear to many businesses and practitioners. Under present law, for example, the amount of the understatement to which the penalty applies is reduced to the extent that the taxpayer had "substantial authority" to justify his or her position. What constitutes "substantial authority" is not defined by statute and, as a result, has caused a great deal of confusion. A taxpayer must now look to a gamut of authority to determine whether "substantial authority" exists, including committee reports, court opinions, regulations, and other written IRS guidance. Given the uncertainty over what constitutes "substantial authority," as well as the meaning of many provisions of the Tax Reform Act, there is a critical need to reexamine this penalty.

Assuming that the negligence penalty were appropriately structured, there is no need for a substantial understatement penalty. The U.S. Chamber recommends repeal of the substantial understatement penalty due to the lack of clarity of the "substantial authority" standard, the questionable tax policy underlying the penalty, and the lack of coordination with other penalties.

If the substantial understatement penalty is not repealed, however, we recommend that the term "substantial authority" be more clearly defined, that the penalty be reduced to a more reasonable level, and that penalty "stacking" be eliminated by coordinating the substantial understatement penalty with other penalties, particularly the negligence, fraud, and delinquency penalties.

Coordination of Taxpayer Penalties. The lack of coordination that now exists among the negligence (Section 6653(a)), substantial understatement (Section 6661), fraud (Section 6653(b)), delinquency (Section 6651), and valuation penalties (Section 6659) is an underlying issue that we believe must be addressed in any reform proposal. With a few exceptions, these penalties are not internally coordinated. It is not uncommon, therefore, for a taxpayer to be subject to four of these penalties on a single understatement of tax. This can and often does lead to draconian results, which serve only to undermine the integrity of the entire tax system. We hope that internal integration of these penalties will be a primary consideration in any reform proposal.

Information Return Penalties. Several dozen penalties relate to failure to file information reports. Examples of penalties relating to transaction-based reports include the $50 per failure penalty relating to 1099 forms, the $500 per failure by brokers to provide notice to payors concerning interest, the $100 penalty for failure of a Domestic International Sales Corporation or Foreign Sales Corporation to supply information, and the $50 penalty for failure to provide a report regarding an individual retirement account. Examples of penalties relating to disclosure information reports include the $50 penalty for failure to furnish a statement of registration to a pension plan participant and the $50 penalty for failure of an issuer to show on the debt instrument original issue discount information. The law literally contains dozens of these information return penalties.

This panoply of penalties, imposed at different amounts, for different infractions, and with different caps, is quite confusing and, at times, can lead to results that are difficult to rationalize. For example, the penalty for failing to disclose a $100 transaction on a 1099 is the same as for failing to disclose a $1,000,000 transaction. Moreover, the penalty for not filing the report is the same as for filing it late. This provides incentive for a taxpayer not to comply if he or she has missed the filing deadline by even a day or two. It seems more logical for the penalty to increase as the period of noncompliance grows. For example, the non-filing penalty could be $50 while the late filing penalty could be $5 per month or a fraction thereof that the report was late up to a maximum of $25. Thus, the system would always contain an incentive to comply.

It seems possible to achieve true simplification in this area by integrating all transaction-based, information return-related penalties into a single penalty that increases as a function of the degree of lateness and the size of the transaction in question, with appropriate maximums and minimums. Similarly, it appears that most disclosure information reports penalties could be integrated into a single penalty of a certain standard amount per failure. There may also be ways of consolidating certain other information reports that businesses are now required to file and, thus, decreasing chances of error and the imposition of unreasonable penalties.

Because of the extraordinary complexity of the existing penalty system, the tax writing committees are faced with the difficult and challenging task of reevaluating the policies underlying the different penalties, cataloguing existing penalties to understand how they interrelate and which penalties overlap, reassessing the criteria and standards for penalty assessments and abatements, and eventually developing a comprehensive package that simplifies the penalty system.

Vast improvements of the penalty system can and must be made to ensure the success of the tax collection system. Penalties should be proportional to the magnitude of the infraction or the level or frequency of noncompliance. Penalties should be administered in a uniform fashion. And the entire penalty system should be made more comprehensible to taxpayers and tax practitioners by eliminating overlapping penalties.

On behalf of the U.S. Chamber, Mr. Chairman, I thank you for the opportunity to testify before your Subcommittee. Your commitment to developing and implementing a lasting penalty reform proposal will enable the tax administration system to operate as smoothly and effectively as possible in future years.

I would be glad to answer any questions.

Attachments

Department of the Treasury
Internal Revenue Service
[redacted]

Date of this notice: FEB. 22, 1988
Taxpayer Identifying Number [redacted]
Form: 941 Tax Period: DEC. 31, 1987

For assistance you may call us at:
[redacted]

[redacted]

Or you may write to us at the address shown at the left. If you write, be sure to attach the bottom part of this notice.

REQUEST FOR PAYMENT

FEDERAL EMPLOYMENT TAX

OUR RECORDS SHOW YOU OWE 400.31 ON YOUR RETURN FOR THE ABOVE TAX PERIOD. THE PENALTY SHOWN BELOW IS BECAUSE YOUR TAX DEPOSITS WERE NOT MADE IN SUFFICIENT AMOUNTS BY THE DATES REQUIRED. IF YOU BELIEVE OUR RECORDS ARE NOT CORRECT, PLEASE SEE THE INFORMATION ABOUT THE AMOUNT YOU OWE ON THE FLAP OF THE ENCLOSED ENVELOPE.

MAKE YOUR PAYMENT PAYABLE TO THE INTERNAL REVENUE SERVICE. PLEASE WRITE YOUR TAXPAYER IDENTIFYING NUMBER ON IT AND MAIL IT WITH THE BOTTOM PART OF THIS NOTICE. YOU SHOULD ALLOW ENOUGH MAILING TIME TO BE SURE WE RECEIVE YOUR PAYMENT BY MAR. 3, 1988.

THANK YOU FOR YOUR COOPERATION.

TAX STATEMENT

TAX ON RETURN	$22,894.45
TOTAL CREDITS	$22,894.43
UNDERPAYMENT	$.02
*PENALTY	400.29
*INTEREST	.00
AMOUNT YOU OWE	$400.31

*SEE CODES 03 ON THE ENCLOSURE FOR AN EXPLANATION OF PENALTY AND INTEREST CHARGES.

To make sure that IRS employees give courteous responses and correct information to taxpayers, a second IRS employee sometimes listens in on telephone calls.

Keep this part for your records [illegible] Form 6488

Return this part to us with your check or inquiry

Your telephone number
Best time to call

[redacted] [redacted]

Department of the Treasury
Internal Revenue Service
[redacted]

Date of this notice: MAR. 21, 1988
Taxpayer Identifying Number [redacted]
Form: 941 Tax Period: DEC. 31, 1987

[redacted]

For assistance you may call us at:
[redacted]

Or you may write to us at the address shown at the left. If you write, be sure to attach the bottom part of this notice.

REQUEST FOR PAYMENT

FEDERAL EMPLOYMENT TAX

OUR RECORDS SHOW YOU OWE 516.66 ON YOUR RETURN FOR THE ABOVE TAX PERIOD. THE PENALTY SHOWN BELOW IS BECAUSE YOUR TAX DEPOSITS WERE NOT MADE IN SUFFICIENT AMOUNTS BY THE DATES REQUIRED. IF YOU BELIEVE OUR RECORDS ARE NOT CORRECT, PLEASE SEE THE INFORMATION ABOUT THE AMOUNT YOU OWE ON THE FLAP OF THE ENCLOSED ENVELOPE.

MAKE YOUR PAYMENT PAYABLE TO THE INTERNAL REVENUE SERVICE. PLEASE WRITE YOUR TAXPAYER IDENTIFYING NUMBER ON IT AND MAIL IT WITH THE BOTTOM PART OF THIS NOTICE. YOU SHOULD ALLOW ENOUGH MAILING TIME TO BE SURE WE RECEIVE YOUR PAYMENT BY MAR. 31, 1988.

THANK YOU FOR YOUR COOPERATION.

TAX STATEMENT

TAX ON RETURN	$16,398.33
TOTAL CREDITS	$16,398.25
UNDERPAYMENT	$.08
*PENALTY	516.58
*INTEREST	.00
AMOUNT YOU OWE	$516.66

*SEE CODES 03 ON THE ENCLOSURE FOR AN EXPLANATION OF PENALTY AND INTEREST CHARGES.

o make sure that IRS employees give courteous responses and correct information to taxpayers, a second IRS employee sometimes listens in on telephone calls.

eep this part for your records [illegible]

Mr. FLIPPO. Thank you, Mr. Burton.
Mr. Moss.

STATEMENT OF HOWARD CHRISTOPHER MOSS, ESQ., WASHINGTON, DC

Mr. MOSS. Thank you, Mr. Flippo. I am Howard Christopher Moss, a self-employed CPA attorney from the District of Columbia. My clients own their own businesses with annual sales of $1 million or less, are relatively young, and have started their businesses within the last few years.

Most of my clients are pretty happy with the penalty system, and I can explain that because I do not represent any organization. I am just a sole practitioner, so I am speaking basically for myself. I am a member of the tax division of the D.C. Bar. I am a member of the American Institute of CPA's. But I am not speaking for them. I am speaking just for my 30 or so small businesses, most of whom average $50,000, $60,000, $70,000 in sales a month.

Most of those people overpay their taxes. Either they file a schedule C on their 1040 and make quarterly estimated payments on that, or they are a corporation, whether it is a C corporation or an S corporation, and they issue themselves, or their wives or children a W-2. For most of these clients, I prepare their tax returns, and for many of them I am their chief financial officer and their corporate legal counsel. They are on the threshold of possibly making it big someday, but most of them cut off their sales at around $100,000 a month at this point.

My basic observation is that they do not mind overpaying their tax as long as if the IRS makes a mistake or if they are unfairly penalized there is some effective way to air their complaints. In the early 1980's—I have been in practice in Washington since 1981—I found it almost impossible to talk directly to the IRS to abate a penalty, for whatever reason, rightly or wrongly.

I started becoming much more actively involved with the problems resolution office in 1985, 1986, and 1987. What has in fact happened to the small practitioner is that they are going directly to problems resolution. Before I even write my first letter to the district director in Baltimore or in Philadelphia, I will call problems resolution immediately, to put a hold on that levee that may be coming, because I do not even trust the system anymore in that respect.

I have basically attached to my testimony a letter that responded to my letter. It says—this was in 1985 and it says, "This is in response to your correspondence of October 16th, 1985." The letter was dated February 18, 1986, almost 4 months later. By then the client would have been levied. By calling directly to problems resolution, the levee was put on hold and eventually the client just gave up and paid the penalty on my advice rather than fight it any further.

But the only thing that I can add to the hearing today is that problems resolution has helped my clients tremendously. Since that is already in place, I think we should explore using them possibly more to solve some of these one-cent problem, or 2-, 3-cent problems that some of these people have, because they can do it. That may not be what Congress intended or the Treasury Department intended for problems resolution, but that is in reality, at least in this district, is what happened.

That is my testimony. Thank you.

[The statement of Mr. Moss follows:]

H. Christopher Moss
Howard Christopher Moss, CPA
212 A Street N.E.
Washington, D.C. 20002

Mr. Chairman and members of the Subcommittee:

Introduction

I am Howard Christopher Moss, a self-employed CPA/Attorney from the District of Columbia. My clients own their own businesses with annual sales of $1,000,000 or less, are relatively young, and have started their businesses within the last few years.

The services I give to my clients range from tax preparation and advice, to acting as chief financial officer for the client with emphasis on tax and business planning. I have been providing such services to local Washington area businesses as a CPA since 1981 and as both a CPA and an attorney since 1985. My observations about civil tax penalties and related issues are based on my experiences with my clients, and any views that I express are my own. My views may not represent the views of any of the various professional organizations of which I am a member.

I have limited my testimony to just a few key observations which may be of value to the committee.

Estimated Tax, Failure to file, Failure to pay

Most of my clients understand the need to make quarterly estimated tax payments. Self-employed individuals who file a Schedule C with their personal tax return also understand that they must at least pay four quarterly deposits equal to the prior years tax in order to avoid penalties for underpayment of estimated taxes. Many of these clients are always overpaid when the return is filed. While many feel it is unfair to constantly be overpaid, many of my clients also accept the fact that their overpayments do not earn interest.

All of my clients understand the need to file their tax return on time and to pay their taxes on time. They understand that to be granted an extension to file does not extend the time to pay the tax.

However, in the rare situation, when one of my clients has for reasonable cause underpaid or paid and filed a tax return late, it has become impossible to effectively communicate with the Internal Revenue Service at the Regional or District level, as far as penalties are concerned, through normal administrative procedures.

What is in fact, happening instead, is that the Problems Resolution Office, at least in my district is doing a great job in handling many of the penalty problems that I have faced.

My observation, therefore, is that while most if not all of my clients believe that these penalties are fair and are necessary, they feel that the Internal Revenue Service is having difficulty administering the many requests for penalty waiver in an expeditious manner.

One example from my many observations is as follows:

June 1985: Taxpayer files 1983 Federal income tax return: Tax $11,284

Aug. 1985: Taxpayer receives notice of penalty-------------and---interest
2,711, 656, 487   1,786
for a total of $5,642.79

Taxpayer responds with various letters and telephone calls in Summer 1985, but no response. I am asked to see if penalty can be waived. On September 5, my letter is sent, asking for waiver. On September 27, 1985 taxpayer receives second notice now for $5,738.81. On October 14, 1985 I send letter requesting that they Service respond to my letter of September 27th. On February 18, 1986 I receive an answer to my letter of October 14, 1985. That letter tells me to explain the reason on the "copy of this letter and return it to us." That was done, and all copies of previous letters were sent as well. On June 2, 1986 another notice was sent, now the amount was $6,152.67 Only July 28, 1986, another notice was sent, now the amount was $6,242.99. On August 5, 1986 I wrote back again, this time enclosing a check from my clients for $6,152.67, after I told my clients to basically just give up. We never heard from the IRS concerning 1983 again.

Conclusion

As operation Link was designed and described in their 1986 publication 1320, the Problem Resolution Program was designed to serve as advocate for taxpayers within the IRS, representing their interests and concerns in the agency decision-making process. As far as penalties are concerned, the small business taxpayer believes that they are fair and necessary. However, the taxpayer also believes that the administration of the whole penalty system has gotten out of hand. Problems Resolution should be used and is being used by tax practitioners to solve many adminstrative problems in the penalty system. My final observation is that many times, various penalties are being fairly reviewed and acted on, in what may be a very efficient manner- through efforts of the Problem Resolution Office--an office which most taxpayers do not really know about.

I thank you for the opportunity to express my views and hope that I can be of assistance to the Subcommittee in the future.

Respectfully Submitted by

H. Christopher Moss

Attached: Letter from IRS dated Feb. 18, 1986.
Letter from IRS dated Aug. 5, 1985.

E 850805

2 28585 14*

Department of the Treasury
Internal Revenue Service
PHILADELPHIA, PA 19255

14

[redacted]

If you have any questions, refer to this information:

Date of This Notice: AUG. 5, 1985

Social Security Number:

Document Locator Number:

Form 1040 Tax Year Ended: DEC. 31, 1983

Call: 962-2590 LOCAL BALTIMORE
488-3100 DISTRICT OF COLUMBIA
or 1-800-424-1040 OTHER MARYLAND

Write: Chief, Taxpayer Assistance Section
Internal Revenue Service Center
PHILADELPHIA, PA 19255

If you write, be sure to attach the bottom part of this notice. Include your telephone number and the best time to call.

Request For Payment

Our records show you owe $ 5,642.79 on your income tax. If you believe this amount is not correct, please see the back of this notice. Make your check or money order payable to the Internal Revenue Service. Please write your social security number on your payment and mail it with the bottom part of this notice. An envelope is enclosed for your convenience. Thank you for your cooperation.

Allow for enough mailing time to be sure that we receive your payment by AUG. 15, 1985

Tax Statement

Total Tax on Return		$ 11,284.00
Tax Withheld	$ 440.00-	
Estimated Tax Payments	.00	
Other Credits	.00	
Other Payments	10,844.00-	
Total Payments and Credits		11,284.00-
OVERPAID TAX		.00
*Penalty		3,855.81
*Interest		1,786.98
Amount You Owe		$ 5,642.79
Subtract Payments We Haven't Included		
Pay Adjusted Amount Due		$

*See Codes 01,09,02,07 on the back for an explanation of penalty and interest charges.

PENALTY AMOUNTS: 01.$2,711.00 02...$656.83 07...$487.98

If you have any questions, you may call or write us—see the information in the upper right corner of this notice. To make sure that IRS employees give courteous responses and correct information to taxpayers, a second employee sometimes listens in on telephone calls

Keep this part for your records.

Form 3446 (Rev. 11-84)

Department of the Treasury
Internal Revenue Service

PHILADELPHIA, PA 19255

In reply refer to:
FEB. 18, 1986

[redacted]

[redacted]

[redacted]

Social Security Number:
Form: 1040
MFT (Internal Use Code):
Tax Period: Dec 31, 1983

Dear Taxpayers:

This is in response to your correspondence of Oct. 16, 1985 about the bill you received on the above account. On rechecking our figures, we found the bill was correct. The explanation at the end of this letter applies to your situation. We hope you will find it helpful.

When a return is filed late and the tax is paid after the due date, both a late filing and a late payment penalty are added. The late filing penalty is 5 percent of the unpaid tax for each month or part of a month the return is late, but cannot be more than 25 percent of the tax not paid when due. The late payment penalty is 1/2 of 1 percent of the unpaid tax for each month, or part of a month, the payment is late, but cannot be more than 25 percent of the tax paid late. If the late filing and late payment penalties both apply for the same month, the combined penalty for that month is limited to 5 percent. The penalties can be removed if you had reasonable cause for filing and paying late. If you believe you had reasonable cause, please explain your reasons on the copy of this letter and return it to us.

When an income tax return is more than 60 days late, a minimum penalty is added of not less than $100 or 100 percent of the balance of tax due on the return, whichever is smaller. The penalty can be removed if you have reasonable cause for filing late. If you believe you had reasonable cause, please explain your reasons on the copy of this letter and return it to us.

When tax is paid late, a late payment penalty is added. The penalty is 1/2 of 1 percent of the unpaid tax for each month or part of a month the payment is late, but cannot be more than 25 percent of the tax paid late. The penalty can be removed if you had reasonable cause for paying late. If you believe you had reasonable cause, please explain your reason on the copy of this letter and return it to us.

When tax is not paid within 10 days of notice and demand, a penalty is added. The penalty is 1/2 of 1 percent of the unpaid portion of additional tax shown on the notice for each month or part of a month

Department of the Treasury
Internal Revenue Service

FEB. 18, 1986

[redacted]

3

the tax remains unpaid, but cannot be more than 25 percent of the unpaid additional tax. The penalty can be removed if you had reasonable cause for not meeting the deadline. If you believe you had reasonable cause, please explain your reason on the copy of this letter and return it to us.

Thank you for your cooperation.

Sincerely yours,

Chief, Taxpayer Assistance Section

Enclosures:
Notice 394
Copy of this letter

Mr. **Flippo**. Thank you very much for that very specific testimony.

Mr. Uslander.

STATEMENT OF GERALD L. USLANDER, PRINCIPAL, WILLIAM M. MERCER MEIDINGER HANSEN, INC., ON BEHALF OF THE ASSOCIATION OF PRIVATE PENSION AND WELFARE PLANS

Mr. **Uslander**. Thank you. I am Gerald Uslander, a principal with the firm of William M. Mercer Meidinger Hansen. I am here today representing the Association of Private Pension and Welfare Plans.

The APPWP is a nonprofit organization founded to protect and foster the growth of this country's private employer-sponsored benefits system. The membership of over 450 includes hundreds of plan sponsors as well as plan support organizations such as insurers, banks, actuarial consulting firms and other benefits professionals. We applaud your foresight in conducting this series of hearings to review the fairness and effectiveness of the penalty provisions in the code.

We are here to address specifically the excise taxes and additional income taxes relating to employee benefit plans. We are concerned about how rapidly these penalty provisions have multiplied since the passage of ERISA. Such penalties are adding layer upon layer of additional complexity to the provision and receipt of employee benefits and may adversely affect an employer's decision to continuing maintaining a plan or to establish a new one.

OVERVIEW

ERISA introduced the notion of excise taxes on employee benefit plans as a sanction against the use of plan assets by fiduciaries for their own purposes or goals, and to encourage compliance with the minimum standards that were added by ERISA in lieu of the more draconian sanction of plan disqualification. Generally, we are in favor of efforts to provide alternative sanctions because of the dire results arising from disqualification.

The recent vintage, of penalty taxes, unlike those that were originally enacted in ERISA to achieve greater fairness, is directed at modifying taxpayer behavior or capturing tax benefits. Nonetheless, the basic purpose of these penalties remains the same as that of all other tax penalties, which is to obtain compliance with the requirements of the code.

To the extent that the excise taxes assure compliance, they are indeed useful. However, excise taxes in the environment of employee benefit plans have additional effects not common to excise taxes imposed in other areas of the law that we have heard about today. That is, they affect the provisions of benefits to employees. Where the imposition of an excise tax will harm plan participants, for example, by forcing the employer into bankruptcy or causing the employer to curtail benefits or terminate a plan, it is not good policy to impose it.

Furthermore, where the undesirable action the tax is intended to prevent or punish affects only the participants in the plan, it would certainly be more sensible and just to require some sort of payment to the plan rather than additional taxes being paid to the Government. We believe, therefore, that many of the excise taxes applicable to employers should be subject to abatement by making payment to the plan involved in lieu of paying the tax.

Finally, while generally a case may be made to support the goal of compliance and therefore the accompanying penalty provisions, the cumulative impact of these taxes produces a mind-boggling morass of rules. As an example, take the ordinary act of electing a distribution from a qualified retirement plan. If the participant elects to receive a distribution too early, and that means generally before age 59½, he is going to pay an additional 10-percent tax on the amount that is included in gross income.

If he elects to defer payments to a date that is too late, which is generally after 70½, there is a 50-percent excise tax on the amount that should have been distributed at age 70½. And even if he begins receiving the benefits at 70½, that 50-percent excise tax can still be imposed if the amount that he receives is less than a prescribed minimum or is paid out over longer than a prescribed period. And both of those are determined under regulations that are over 50 pages in length and are nearly incomprehensible.

Finally, even if the participant correctly handles the timing; that is, the distribution does not begin either too early or too late and it is spread over the correct period so that each distribution is not too small, the participant can be faced with an excise tax of 15 percent if the benefit is too large. In this case, even where the too large is attributable solely to good investment returns. Like Goldie Locks and her porridge, every taxpayer has to find the distribution which is just right.

Now this confusing structure of penalty provisions is symptomatic of the real problem, which is the underlying complex series of minimum standards for qualified plans. Accordingly, our concern might not be so much with the penalties, per se, as with the underlying statutory structure governing employee plans.

However, recognizing that we may be dealing today with the symptoms rather than the disease, I want to briefly comment on just a couple of excise taxes that are in greatest need of modification. We have examined several others in our written statement, but in the interest of time I will not go into all of them.

There is a 15-percent excise tax that would be imposed on individuals and on estates to the extent that aggregate distributions from all tax favored arrangements exceed a threshold amount in any one year. There are also some complicated grandfather rules which would protect a certain amount of accrued benefits in existence on August 1, 1986. The threshold level is generally $150,000 or $112,500 and—that figure would be indexed—if it is greater. Or that must be used if the grandfather rule is elected.

The excise tax was originally intended, and it first appeared as part of the original simplification proposals in the Tax Code, to replace the complex section 415 limits on benefits and contributions where a taxpayer was in two or more plans sponsored by the same employer, with a simpler and more equitable scheme for limiting retirement income. However, when it was enacted, it did not replace that combined plan limits but it was put in in addition to it.

One of the purposes of the excise tax was to prohibit the accumulation of multiple maximum benefits from several employers as well as individual retirement savings and an IRA. No additional tax is really necessary any longer to accomplish this goal. IRA deductions, for one, are now eliminated for employees who earn more than a certain amount and who participate in an employer-sponsored retirement plan, so there is not any need to encompass the IRA benefits in this limit.

Similarly, in the case of a 403(b)(3) tax sheltered annuity, which is subject to its own limits, contributions are coordinated with other elective deferrals and with the 415 limits. So the only real gap in this scheme involves the high paid individual who is employed by more than one totally unrelated employer and who earns the maximum benefit under each one of those plans. In our view, this situation is so rare that the imposition of the excise tax simply to cover it is completely unwarranted.

The structure of the excise tax is extremely complex, and there are a lot of unanswered questions that we mentioned in detail in our written testimony and I will not go through all of them. While it is hoped that the regulations will be able to answer these questions, individual plan participants should not be expected to have to deal with this level of complexity, particularly when the benefits provided under various plans are beyond their control.

The complex and uncertain nature of this penalty does not increase compliance, as the Joint Committee on Taxation noted may be the case with other penalties in the code. In fact, the effect in this case may be quite the opposite, since even tax professionals and IRS personnel may misconstrue the rules.

The excise tax is inequitable in that it applies across the board to benefits from defined benefit plans and to all amounts paid from savings type plans. It may be in fact a penalty on good investment return, which is obviously beyond the control of the individual participant. As such, the tax is contrary to the policy of providing incentives for savings and capital formation.

This excise tax poses severe difficulties for any individual potentially subject to it. One can argue that such an individual who has a benefit of more than $150,000 per year can easily afford the type of professional assistance necessary to respond to these problems. However, this may not be true because it is quite likely that a thrifty employee or a shrewd investor has attained his normal retirement age without ever having to have hired professional assistance. And even if he tried, he might not be able to find anybody that can really understand the ramifications of this excise tax.

The bottom line is, we believe this excise tax does not meet any perceived need and we recommend that it be eliminated.

The second and last one that I want to just mention is a 10-percent excise tax on employers making nondeductible contributions to qualified retirement plans. The purported abuse at which this one was directed, that of placing large amounts of funds into plans in order to obtain the advantage of the tax deferral on the income generated is simply not a common occurrence.

There are several reasons why employers do not, as a general rule, make unnecessary contributions to plans. First of all, it is impossible to recoup any excess amounts contributed to the plan unless you terminate it or unless a mistake of fact can be established.

Second, even if you terminate it, there is a 10 percent excise tax to get that money back.

Third, businesses usually cannot tie up funds indefinitely. They have other uses for their money.

Fourth, contributions in excess of those needed to fund the plan may not be deducted.

However, after the recently enacted funding rule changes that imposed the new lower full funding limitation, many employers will be subject to the excise tax, not because they have any abusive intent but because they are either forced or required to make contributions that are no longer deductible.

The change in the full funding limitation will cause significant year to year variations in the deductible amount. An employer who makes level contributions for budgetary purposes can still incur the excise tax periodically because of swings in termination liability, on which the full funding limitation is based, due to variations in interest rates and the composition of its work force.

Also where an employer is required by the terms of a collective bargaining agreement to make certain contributions to a multiemployer plan, which is or becomes overfunded, the employer will incur the excise tax, although it can't reduce its level of contributions because of the collective bargaining and, therefore, has no control over the terms of the plan. This excise tax should also be eliminated.

Let me conclude by emphasizing that while we generally support the use of excise taxes as a means of ensuring compliance with the requirements of the code in lieu of the sanction of plan disqualification, or in the case of the COBRA health care continuation provisions, the denial of deductibility, we believe that the taxes which affect individual participants and beneficiaries should be made substantially less complicated. Certainly these excise taxes should be limited or eliminated entirely where they are inappropriate or ineffective in meeting the purposes for which they are intended.

In addition, excise taxes which are designed as both a deterrent and a penalty should be subject to abatement in the event that restitution is provided to the plan and its participants.

Finally, we recognize that, in certain cases, complexity is the result of the underlying statutory standards and not of the penalty provisions per se. In these instances, a careful review of the policy goals and their implementation may be necessary.

Thank you.

[The statement of Mr. Uslander follows:]

STATEMENT

OF

THE ASSOCIATION OF PRIVATE PENSION AND WELFARE PLANS

Mr. Chairman and members of the Subcommittee, I am Gerald L. Uslander, a Principal in the firm of William M. Mercer Meidinger Hansen, Inc. I am here today representing the Association of Private Pension and Welfare Plans ("APPWP"). The APPWP is a nonprofit organization founded to protect and foster the growth of this country's private employer sponsored benefits system. Our membership of over 450 includes hundreds of plan sponsors as well as plan support organizations such as insurers, banks, actuarial firms and other benefits professionals.

Mr. Chairman, we applaud your foresight in conducting this series of hearings to review the fairness and effectiveness of the penalty provisions in the Code. We are here to address specifically the excise taxes and additional income taxes relating to employee benefit plans. We are concerned about how rapidly these penalty provisions have multiplied since the passage of ERISA. Such penalties are adding layer upon layer of additional complexity to the provision and receipt of employee benefits, and may adversely affect employers' decisions to continue maintaining existing benefit plans or to establish new ones.

Overview

ERISA introduced the notion of excise taxes on employee benefit plans as a sanction against the use of plan assets by fiduciaries for their own purposes, and to encourage compliance with certain minimum standards, in lieu of the more draconian sanction of plan disqualification. Generally, we are in favor of efforts to provide alternative sanctions to disqualification of the plan because of the dire results arising from disqualification. However, the recent vintage of penalty taxes -- unlike those enacted in ERISA to achieve greater fairness -- is directed at modifying participant/taxpayer behavior or recapturing tax benefits.

Nonetheless, the basic purpose of these penalties remains the same as that of all other tax penalties: to obtain compliance with the requirements of the Code. To the extent that the excise taxes ensure compliance, they are useful. However, excise taxes in the environment of employee benefits plans have additional effects not common to excise taxes imposed in other areas of the law; that is, they affect the provision of benefits to employees. Where the imposition of an excise tax will harm the plan participants (e.g., by forcing the employer into bankruptcy or by causing the employer to curtail benefits or terminate the plan), it is not good policy to impose it. Furthermore, where the undesirable action the tax is intended to prevent or punish affects only plan participants, it would be more sensible and just to require some sort of payment to the plan rather than additional taxes to be paid to the government. We believe, therefore, that many of the excise taxes applicable to employers should be subject to abatement by making payment to the plan involved in lieu of paying the tax.

Finally, while generally a case may be made to support the goal of compliance and therefore the accompanying penalty provisions, the cumulative impact of these taxes produces a mind-boggling morass of rules. Take, for instance, the ordinary act of electing a distribution from a tax-qualified retirement plan. In this situation, if the participant/taxpayer elects to receive a distribution too early -- generally before age 59-1/2 with numerous exceptions -- there is an additional 10 percent tax on the amount includible in gross income. On the other hand, if the participant/taxpayer defers the payment of benefits to a date which is too late -- generally, after age 70-1/2 -- there is an excise tax of 50 percent of the amount which should have been distributed. And, even if the participant begins receiving benefits by age 70-1/2, the 50% excise tax will be imposed if the amount received in any year is less than a prescribed amount, or is paid out over longer than a prescribed period, determined under regulations that are over 50 pages in length and are nearly incomprehensible. Finally, even if the participant/taxpayer correctly handles the timing -- that is, the distribution begins neither too early nor too late and is spread over the correct period so each distribution is not too small -- the participant/taxpayer faces an excise tax of 15 percent if the benefit is too large. This is the case even where the "too large" is attributable solely to good investment returns. Like Goldie Locks and her porridge, every participant/taxpayer must find the distribution which is "just right."

This complex structure of penalty provisions is symptomatic of the real problem, which is the underlying complex series of minimum standards for qualified plans. Accordingly, our concern may not be so much with the penalties _per se_ as with the underlying statutory structure governing employee plans. However, recognizing that we may be dealing today with the symptoms rather than the disease, let us examine briefly certain of the excise taxes which in themselves are in greatest need of modification.

Tax on Excess Distributions

A 15% excise tax is imposed on individuals to the extent that aggregate distributions from tax-favored arrangements exceed a threshold amount in any year. Complicated grandfather rules exist for individuals whose accrued benefits under all applicable retirement arrangements exceeded five times the threshold level on August 1, 1986. The threshold level is generally $150,000 or $112,500, indexed, if greater or if the grandfather rule is elected. This excise tax was intended, as part of the original proposals for simplification in the tax code, to replace the complex limitations on benefits and contributions under two or more plans of an employer with a simpler and more equitable scheme for limiting retirement income. However, as enacted, it does not replace the combined plan's limitations but applies in addition thereto, and it is neither simple nor equitable.

While one of the purposes of the excise tax was to prohibit the accumulation of multiple maximum benefits from several employers as well as individual savings in an IRA, no additional tax is necessary to accomplish that goal. Since IRA deductions are now eliminated for employees earning over a threshold amount who participate in employer plans, no need to encompass IRA benefits in an overall limitation exists. Similarly, contributions to 403(b) annuities are coordinated with other elective deferrals and with the 415 limits. Thus, the only gap in this scheme of limitations involves the high-paid individual employed by several completely unrelated employers, who earns maximum benefits under plans of each employer. In our view, this situation is so rare that the imposition of the excise tax simply to cover it is completely unwarranted.

The structure of the excise tax is extremely complex. For example, it is unclear how and when benefits are to be valued for determining the grandfathered amounts, how and when the election is to be made, how rollovers are to be treated, how lump sum distributions are to be treated, whether income on grandfathered amounts is also grandfathered, and how the grandfather rule is to be applied when there are two or more plans. Among the major unanswered estate tax issues are whether the employee's election applies to both the excise tax payable prior to death, and to the excise tax on the estate; whether the employee's investment in the contract is subject to the excise tax on the estate (it is specifically excluded from the lifetime excise tax); whether the proceeds of life insurance in a plan are subject to the tax; how the decedent's life expectancy and the present value of all benefits, as well as the present value of the limitation amount for all years are to be determined; whether a surviving spouse's interest is to be subtracted before determining present value; who pays the tax; and how this tax interacts with existing estate and income tax rules, for example, rules on credits and deductions, and community property laws. Further, it is possible that this provision could create a taxable estate where none existed before. While it is hoped that regulations will be able to answer most of these and other questions, individual plan participants should not be expected to have to deal with this level of complexity, particularly when the benefits provided under various plans are beyond their control. The complex and uncertain nature of this penalty does not increase compliance, as the Joint Committee on Taxation noted may be the case with certain other penalties in the Code (JCS-9-88 pg. 21). In fact, the effect in this case may be quite the opposite, since even tax professionals and IRS personnel may misconstrue the rules.

The excise tax is inequitable in that it applies across-the-board to benefits from defined benefit plans and to all amounts paid from savings-type plans, where it may be, in fact, a penalty on good investment return, a factor which is beyond the control of the individual. As such, the tax is contrary to the policy of providing incentives for savings and capital formation. Moreover, it may be possible for individuals to manipulate their receipt of benefits in order to avoid imposition of this tax, if they are aware of it and if they are sophisticated enough in pension tax law to recognize in advance that they may have the problem. However, the majority of individual plan participants generally do not have the advantages of financial resources and sophisticated research and counsel necessary to even understand the tax, much less maneuver to avoid it.

As demonstrated by the issues previously alluded to, this excise tax poses severe difficulties for any individual potentially subject to the tax. One may argue that an individual who has accrued as much as $150,000 per year may easily afford the type of professional assistance necessary to respond to these problems. This however, may not be true. It is quite likely that a thrifty employee or shrewd investor may attain normal retirement age without ever needing the type of professional assistance which will be necessary to respond to the problems created by the excise tax. Moreover, even if this barrier did not exist, there will be very few professionals who can provide the assistance necessary to respond to many of the questions raised by this excise tax. We believe this tax should be eliminated.

Tax on Nondeductible Contributions

A 10% excise tax is imposed on employers making nondeductible contributions to qualified plans. The purported abuse at which this penalty is directed:placing large amounts of funds into plans in order to obtain the advantage of tax deferral on the income generated) is simply not a common occurrence. There are several reasons why employers do not, as a general rule, make unnecessary contributions to plans. First, it is impossible to recoup excess amounts contributed to a plan without terminating the plan (unless a mistake of fact can be established). Second, amounts recovered at plan termination are themselves subject to a 10% excise tax. Third, businesses cannot tie up funds indefinitely, but have other uses for their money. Fourth, contributions in excess of those needed to fund the plan may not be deducted.

However, after the recently enacted funding rule changes, many employers will be subjected to this excise tax, not because they have any abusive intent, but because they are required to make contributions which are no longer deductible. For example, the change in the full funding limitation, which eliminates the deduction for contributions in excess of those needed to provide 150% of termination liability, will cause significant year-to-year variations in the deductible amount. An employer who must make level contributions for budgetary reasons may incur the excise tax periodically, because of swings in termination liability due to variations in interest rates and the composition of its workforce. Furthermore, the new funding provisions require quarterly payment of estimated contributions. If the estimate exceeds the full funding limitation, the excise tax will be incurred despite the fact that the contributions were required to be made and once made cannot be withdrawn. Finally, where an employer is required by the terms of a collective bargaining agreement to make certain contributions to a multiemployer plan which is or becomes overfunded, the employer will incur the excise tax although it cannot reduce its level of contributions and has no control over the terms of the plan. This excise tax should simply be eliminated.

COBRA Excise Tax

The Consolidated Omnibus Budget Reconciliation Act of 1986 (COBRA) enacted requirements for continuation of health insurance coverage for employees and their beneficiaries whose coverage is terminated. The sponsor of a plan which violates the continuation coverage requirements on any single day, is denied the deduction for the cost of health care coverage provided under all group health plans of the employer during the taxable year. We are gratified that the Congress is considering substituting an excise tax for COBRA violations in lieu of the draconian sanction currently in the law, and giving employers an opportunity to lessen penalties by curing the violation. We are concerned, however, that the level of the excise tax proposed is far in excess of that justified by the nature of the violation. It more nearly resembles criminal sanctions than an equitable resolution of a violation of the continuation coverage requirements. In fact, the $500,000 maximum is the same penalty as that imposed on corporations for felonious attempts to evade or defeat any tax. We hope that, in enacting this new excise tax, the Congress will make every effort to tailor the penalty to the violation, by carefully fitting the objectives of equity for plan participants and beneficiaries, adequate incentives for compliance, and protection for the long-term provision of benefits.

Tax on Failure to Meet Minimum Funding Standards

A nondeductible excise tax is imposed on an employer who fails to make contributions to a pension plan sufficient to satisfy the minimum funding requirements. Any other employer that is a member of the same controlled group as the sponsoring employer is jointly and severally liable for the penalty tax. This excise tax is 10% (5% for years prior to 1988) of the insufficiency; an additional tax equal to 100% of the deficiency is assessed if the deficiency is not eliminated within a certain period. This tax was originally proposed in order to provide a less severe sanction than plan disqualification for failure to meet the minimum funding standards. While this was, and remains, a worthy goal, we do not believe the excise tax is either appropriate or effective as it is currently structured.

Where an employer's failure to meet the minimum funding standards is attributable to financial distress, it is illogical to suppose that the employer will have sufficient funds to pay an excise tax equal to 110% of the deficiency. The imposition of this tax could force such an employer into bankruptcy. What can possibly be gained from such a scenario? The plan participants are the people being harmed by the failure to fund; yet the effect of the measures designed for their security is to leave them totally without security.

The purpose of these taxes is clearly to provide a necessary disincentive for failure to fund plans, thus ensuring compliance with the minimum funding standards. Whether or not the first tier excise tax accomplishes this purpose, we believe the second tier tax goes far beyond the level needed as a disincentive, and ultimately harms plan participants rather than simply penalizing the plan sponsor. The minimum funding standards themselves were designed for the protection of plan participants and beneficiaries. The excise taxes were designed to ensure compliance with these standards. But where the standards are not met, the fact that the employer has had to pay a large excise tax to the government does nothing to protect the plan participants. In order to retain the nature of a strong disincentive for failure to fund, while making the penalty both more appropriate for the misbehavior and more equitable, we would suggest that the second tier excise tax be replaced by some level of compensation to be paid to the plan for the benefit of its participants.

Tax on Funded Welfare Benefit Plans

A tax of 100% of the disqualified benefit is imposed on an employee welfare benefits plan which provides certain benefits to key employees or provides discriminatory benefits. We believe this penalty is too severe. In addition, where the parties harmed by the action the penalty is designed to curtail are easily identified (i.e., they participate in the plan), we suggest that the tax be subject to abatement if, for example, the employer makes a contribution to the plan for nonkey and nonhighly compensated employees.

Conclusion

In conclusion, while we generally support the use of excise taxes as a means of ensuring compliance with the requirements of the Internal Revenue Code in lieu of the sanction of plan disqualification or denial of deductibility, we believe that the taxes which affect individual participants and beneficiaries of plans should be made substantially less complicated. Certain of these excise taxes should be limited, or eliminated entirely, where they are inappropriate or ineffective in meeting the purpose for which they were intended. In addition, excise taxes which are designed as both a deterrent and a penalty should be subject to abatement in the event that restitution is provided to the plan and its participants. Finally, we recognize that, in several cases, complexity is the result of the underlying statutory standards, and not of the penalty provisions per se. In these instances, a careful review of the policy goals and their implementation may be necessary.

Thank you again for the opportunity to present our views today.

Mr. Flippo. Thank you very much.

Mr. Salkind.

STATEMENT OF CHESTER J. SALKIND, EXECUTIVE DIRECTOR, AMERICAN SOCIETY OF PENSION ACTUARIES

Mr. Salkind. My name is Chester Salkind. I am the executive director of the American Society of Pension Actuaries. Our organization has approximately 2,500 members who provide consulting actuarial or administrative services to qualified retirement and other benefit plans.

Before I get into a discussion of certain specific penalties, I would like to perhaps put this matter into a broader context, and that is the relation between the penalties and the constant changes in the tax laws. These have been alluded to before, but it's been particularly acute in the qualified plan area, TEFRA in 1982, REA and DEFRA in 1984, TRA in 1986, and OBRA in 1987, all made widespread changes in the rules relating to qualified retirement plans.

There were other statutes that affected qualified plans in less sweeping ways but, nevertheless, made additional changes.

The result is that there is a high degree of uncertainty as to what are the rules, and the rules with which compliance is required. And if you don't know what you are supposed to comply with, of course, you do run into the possibility of penalties.

Again, I would like to spend a little more time just putting this into perspective and suggesting a solution.

The Congress almost got there but didn't quite get there in the TRA 1986. In section 1141, there was spelled out nine separate areas where IRS was to issue final regulations by February 1, 1988. Most of these areas related to nondiscrimination and coverage, and the effective date was to be the first plan year beginning in 1989. So the statutory scheme basically was that the regulations would be issued by February 1, and then they would go into effect in 1989.

The failure, if you will, of that arrangement was that the effective date wasn't ultimately conditioned on the issuance of regulations. These provisions will go into effect in 1989, and will not be delayed because of the fact that no final regulations have been issued with respect to any of the nine areas.

Again, just for technical clarification, most of the effective dates here were 1989. There were some areas which had earlier effective dates. But basically that was the scheme. These were complicated matters. The regs would be issued, and industry and plan sponsors and everybody else would have at least 11 months to figure out what they were supposed to do. And there would be some orderly scheme, orderly procedures to complying with the new rules.

And as I say, unfortunately, the final regs have not shown up in any of the nine areas, and I am not particularly being critical of the IRS in this regard. I think they have been given a task that is, at the minimum, exceedingly difficult, and perhaps at the maximum impossible.

And my suggestion, and the suggestion of our organization is that, with respect to any significant changes in the tax law that the effective date be geared in an absolute sense to the issuance of final regulations. Again, we are just expanding a bit on what was done in section 1141 and suggest that the statute proclaim that these provisions shall not go into effect until, let's say, the first plan year beginning at least 11 months, or at least a year, after the issuance of final regulations.

And we think this does affect the penalty situation because, again, the penalties come into play when you fail to comply and, in most cases, in the vast bulk of cases, the failure to comply is a result of an inadvertent error. People simply don't know what to do. And I say this is true at the highest levels.

My job gives me access to people who are a lot smarter than I am, in the employee benefits industry, both in and outside of our organization. And there is a lot of uncertainty in a lot of areas as to what to do. The Government does not know, the practitioners do not know. And the result of all this is, again, it is going to exacerbate the problem of the penalties. And I do suggest this as a solution to future legislation. In fact, I would go so far as to say that Congress ought to go back and change the effective dates of these TRA 1986 provisions to make them effective after the final regulations are issued.

I will discuss three specific penalties, and again Mr. Uslander has touched upon a couple of them, so I won't go into too much detail.

One that hasn't been mentioned until now I would like to discuss in some detail, is the penalty for overstatement of pension liabilities under section 6659(a) of the Internal Revenue Code. It is a penalty which comes into play if there is an underpayment of taxes due to overstatement of pension liabilities. And again we are talking about defined benefit plans and the calculations that the enrolled actuary has to make, an enrolled actuary who is licensed by the Federal Government and has to go through rigorous examination and experience requirements. The calculations are affected by his estimates as to future interest and inflation rates, turnover rates, typical retirement ages, mortality, and other factors far into the future. It is a very complex calculation.

It is almost difficult to get it exactly right. You try to get it as accurately as you can. But we think it is inappropriate that the statute puts such a heavy penalty on the failure to get it exactly right in this situation.

Now, again, the statutory scheme is that it falls on the employer. But the reality of the situation is that if the employer has to pay additional amounts, he will, of course, go back to the enrolled actuary who made the calculations.

So, under these circumstances, you are going to find the enrolled actuaries taking a very cautious attitude, which means that the amounts put into the plans will be lower than they otherwise would. They feel exposed in this situation. You have a format where the combined penalty for overcontributing, for claiming deductions now instead of later, can be as great as 40 percent of the overcontributions. That is the 30 percent maximum you get under 6659(a) and the 10 percent nondeductible penalty that you get under 4975.

So you have built into the statute arrangements which are going to encourage minimum funding as against generous funding. And we certainly don't think this is in the long-term interest of the future pensioners of America. And I am sure you are all familiar as to the reasons why we need to build up these funds to take care of our aging population.

And again I don't want to repeat a lot of what has already been said. Mr. Uslander discussed in some detail the non-deduction penalty under 4972. This is the 10-percent penalty. It applies more broadly than the penalty I previously discussed in the sense that it is applicable to plans other than defined benefit plans. But, again, it will come into play mostly in the defined benefit area because, in this area, the calculations are more complicated than with respect to the defined contribution plan.

And, again, the statutes that have been passed in recent years have made them even more complicated than ever. And I'll just cite two illustrations of that.

The Tax Reform Act of 1986 replaced the 10 years of service requirement for a maximum benefit with 10 years of participation requirements, and the implications are still not clear.

And OBRA 1987, as was mentioned, put in a new full funding limit, and beginning in 1989 you have to make quarterly contributions.

So all these affect the initial inherent complications of calculating the amount that you can contribute to the defined benefit plan. So we think the current structure of the 10 percent nondeduction penalty is inappropriate.

We do have a kind of a quick fix for this, which is that the statute requires the withdrawal of the excess amount very promptly to avoid the 10-percent penalty. And IRS has stated that such amount cannot be withdrawn other than under very narrow circumstances relating to a mistake of fact, without disqualifying the plan until after it determines upon audit that the contribution is excessive. And the audit would not occur in time.

So our solution is to allow withdrawal of the excess contributions within the year following the year of contribution, without waiting for an IRS audit, without any disqualification and without the imposition of the 10-percent penalty. And this will allow time for the corrections of errors.

And the third penalty that I would like to discuss, and again I will make it very brief, is the penalty imposed on participants in qualified plans or individual retirement accounts to the extent they fail to take a distribution of a minimum amount commencing at the time they reach age 70½. And again, as has been mentioned before, the penalty is quite draconian in nature. It is 50 percent of the amount the participant fails to take, and is in addition to the income tax that the participant will have to pay on that amount. And again the calculation of the minimum amount that you have to distribute is a very complicated one. Mr. Uslander mentioned the 50-page regulations, and it takes quite a perceptive individual to figure out what you are supposed to do. In fact, it is difficult in many situations for the most perceptive individual to figure out what you are supposed to do.

And our solution for this is two modifications. First, the taxpayer should have a grace period of a year following the date the IRS rules that a prior withdrawal was inadequate to withdraw the required additional amount without any penalty, providing the taxpayer demonstrates that the calculation upon which the prior withdrawal was based was made in good faith.

And, second, we would reduce the penalty from 50 to 10 percent.

The only other penalty I would like mention is again one that has been mentioned, which is the 15-percent penalty on excess distributions. It duplicates the limitations under section 415(e) on the combined plans, the amount you can get under several plans, which was the alleged purpose of the 15-percent penalty.

So it would seem duplicative, and it also seems like it is a tax on superior investment performance. So we certainly think this should be looked at.

And I would be happy to answer questions or provide any additional information.

[The statement of Mr. Salkind follows:]

STATEMENT OF CHESTER J. SALKIND, EXECUTIVE DIRECTOR AMERICAN SOCIETY OF PENSION ACTUARIES

The American Society of Pension Actuaries is an organization whose 2,500 members are pension consultants, actuaries and administrators of qualified retirement plans. We welcome the opportunity to address this Subcommittee about our concerns with certain penalties in the tax code that affect such plans.

We will discuss in detail three specific areas with which we are particularly concerned - 1) The penalty for overstatement of pension liabilities under Section 6659A of the Internal Revenue Code (IRC), the penalty for non-deductible contributions under Section 4972 of the IRC, and the penalty for failing to take the minimum required distribution after age 70 and 1/2 under Section 4974 of the IRC.

Section 6659A imposes a penalty of up to 30% of the underpaid taxes attributable to the overstatement of pension liabilities in a defined benefit plan.

To see the real harm of Section 6659A, you have to appreciate the difficulty and uncertainty of cost estimates in defined benefit plans. To make his calculations as to the appropriate contributions to a defined benefit plan, the Enrolled Actuary, who is licensed by the Federal Government, must estimate interest and inflation rates, turnover rates, typical retirement ages, mortality, and other factors far into the future. The difficulty of these predictions is one reason why the Enrolled Actuary is trained and tested so rigorously. Of course, frequent changes in the pension laws complicate this task, as will be discussed later.

Most IRS agents have nothing like this training in actuarial science. They may be misled by current interest rates and other current factors. This misunderstanding sometimes leads them to conclude that the Enrolled Actuary's cost estimates are too high. When the agent has weapons like Section 6659A, the Enrolled Actuary becomes virtually powerless in the fight for contributions adequate to protect our nation's workers.

The penalty of Section 6659A is nominally imposed on the employer. However even the most unimaginative observer knows where the penalty will come to rest. Suppose an employer bases contributions and deductions on the Enrolled Actuary's calculations. Supose the deductions are disallowed and a penalty tax is assessed. As night follows day, the taxpayer will turn to the Enrolled Actuary for reimbursement of the penalty.

A comparison of penalties for overfunding with those for underfunding gives the Enrolled Actuary a clear message on how best to control his personal liability. The penalty for underfunding, for jeopardizing our workers' retirement security, is generally 10% of the underpayment (beginning in 1989). The combined penalty for overcontributing, for claiming deductions now instead of later, can be as great as 40% of the overcontribution, when the 30% overstatement penalty is added to the 10% non-deduction penalty described below.

As a matter of self preservation, the Enrolled Actuary will have only one course. Cost estimates will have to seem reasonable to IRS agents, whether or not the Enrolled Actuary really believes they are adequate. In cases of uncertainty, the lower estimate will have to prevail over the higher. The inevitable result will be a bias favoring underfunding. This does not bode well for the future pensioners of America. It also will have a negative impact on the PBGC, the Federal agency whose responsibility is to provide a specified level of guaranteed benefits in certain defined benefit plans.

Because Section 6659A will negatively and significantly impact the benefit security of millions of Americans by encouraging lower funding levels, we urge its outright repeal.

Under Section 4972 of the Internal Revenue Code, for tax years of an employer beginning after 1986, contributions made to a retirement plan which are not deductible at the time made are subject not only to an income tax, but also to a ten percent penalty tax. The penalty is calculated by taking the amount contributed that is non-deductible and multiplying that amount by ten percent.

If the non-deductible amount remains in the plan beyond the year in which it was contributed and remains non-deductible in future years, the ten percent penalty is reimposed each year until the amount is deductible. The non-deduction penalty is imposed automatically, without reference to the reason the non-deductible amount was contributed.

We have already discussed above the difficulties involved in determining the appropriate contributions to a defined benefit plan. Section 4972 is applicable to a broader range of plans, but the majority of problems will undoubtedly arise with respect to defined benefit plans where the calculations are more complex.

It should also be noted that there have been a number of changes in TRA '86 and the Omnibus Budget Reconciliation Act of 1987 (OBRA '87), which change the calculation of the maximum deductible contributions.

For example, TRA '86 replaced the 10 years of service requirement for a maximum benefit under a defined benefit plan with a 10 years of participation requirement, and all the implications of this change are still not clear.

OBRA '87 established a new full funding limit which imposes a different and, for the moment at least, unclear method of determining the amount that can be contributed to a defined benefit plan and deducted. Plan actuaries are unable to determine with any certainty what that full funding limit is at this point becuase the law itself is not clear and the Internal Revenue Service has been unable thus far to provide significant guidance.

Furthermore, under OBRA '87, for plan years beginning in 1989, an employer is required to fund plan benefits by making estimated quarterly payments during the year. The employer often will not know, until the year is over, whether or not the quarterly estimates were correct. If the quarterly estimates were too high, the excess amount is subject to the ten percent penalty tax as a non-deductible penalty.

The statute requires the withdrawal of the excess amount very promptly to avoid the 10% penalty, and IRS has stated that such amount cannot be withdrawn (other than under very narrow circumstances relating to a "mistake of fact"), without disqualifying the plan until after it determines upon audit that the contribution is excessive. Such an audit would not occur within a time frame that would allow avoidance of the penalty.

We believe there is a relatively simple solution to this problem - allow withdrawal of the excess contributions within the year following the year of contribution, without waiting for an IRS audit, without disqualification, and without imposition of the ten percent penalty. This will allow time for the correction of errors.

TRA '86 imposes a penalty on participants in qualified plans or individual retirement accounts to the extent they fail to take a distribution of a minimum amount commencing at the time they reach age 70 and 1/2. That penalty is 50% of the amount the participant fails to take, and is in addition to the income tax the participant will have to pay on that amount. The calculation of that minimum amount is different for defined benefit and defined contribution plans, and can be a very complex calculation.

Because the rules for developing the minimum amount are so complex, errors will continue to be made in calculating those minimum amounts. These errors, which will occur even with good faith efforts to comply with the law, will subject the participant to a loss of half of the benefit that should have been distributed but was not because of the error. The severity of the penalty, in light of the difficulties that can be encountered in determining the minimum amount, and the fact that errors can be made through reasonable interpretations of the law, is of great concern to our membership.

We believe the penalty is best described as draconian, and suggest two modifications.First, the taxpayer should have a grace period of a year following the date the IRS rules that a prior withdrawal(s) was inadequate to withdraw the required additional amount without any penalty, providing the taxpayer demonstrates that the calculation upon which the prior withdrawal was based was made in good faith. Second, the amount of the penalty should be reduced to 10% instead of 50%.

An additional general comment that we would like to make is that the frequency of changes in the tax laws relating to retirement plans has caused great difficulty to all those involved in these plans, including making the penalties described above more likely to come into play. We suggest that no significant change in the tax laws relating to retirement plans become operative until plan years beginning at least a year after the issuance of final regulations implementing these changes. Congress can spell out, as it did in Section 1141 of TRA '86, the areas where it expects final regulations to be issued, but it should then take the additional step of delaying the effective dates of these areas until plan years beginning at least a year after these final regulations are issued.

There are other penalties which should be reviewed, such as the 15% penalty on excess distributions. As currently constituted, this tax penalizes superior investment performance.

We would be happy to provide any additional information upon request.

Mr. **Flippo**. Thank you. Thank you very much.

Does the distinguished Chair wish to question at this time?

Chairman **Pickle**. Yes, very briefly.

First, I want to say to this panel that it is the intention of this subcommittee to study and have additional hearings on these things either this fall or next year——

Mr. **Salkind**. Thank you.

Chairman **Pickle** [continuing]. To try to advance this set of recommendations that accomplishes the best of the recommendations made. It will not be easy. I think you recognize that. Each of you testified on how you think penalty provisions ought to be changed. I wish I could tell you what direction we are headed. We don't know that ourselves, but we've determined we ought to try to do it because it's important to have a fair and effective penalty system.

If we've got 150 different penalties, somehow they ought to be combined, and in the effort to do so, we may end up with something more complex than we've got now. So overall, the intent is to see if we can't advance something because it's needed. We'll need your cooperation.

Surely we can get a better system than we've got today, and I think the Internal Revenue Service will cooperate with us. They've indicated that they will do so.

Now, I don't have anything to ask except one or two specific questions here. I notice, Mr. Schneier, that this morning the SBA man testified that there ought to be a warning statement to a taxpayer if that taxpayer in the last 3 years hasn't been guilty of a similar offense that he's currently being reviewed on.

How do you feel about that as a recommendation? Do you think that's practical?

Mr. **Schneier**. I think it would probably have some administrative difficulties of its own in terms of defining when do you give—on what basis do you give a warning? What kind of an event warrants a warning as opposed to something more severe?

Chairman **Pickle**. You're saying that in some instances perhaps you could do that, but in others, the general rule would be to penalize?

Mr. **Schneier**. Yes. I certainly wouldn't support——

Chairman **Pickle**. I think probably it would be sort of an add-on risk to protect them also because if a taxpayer knew that he was going to get a warning before any penalty is assessed, he may drive the extra mileage, you know, claim as much as he could if he's only going to get a warning.

And I don't know whether that is practical. Although the principle is sound, we need to figure out some way it could be done in certain circumstances. Are you saying that in limited instances it might be done but not as a general practice?

Mr. **Schneier**. If you had a very small payroll tax penalty problem where there's nickel or a very small problem because maybe of a late payment of 5 or 10 days. In this case if the penalty was maybe not quite as severe that first time, a late payment occurs, that may be more appropriate.

Chairman **Pickle**. Now, Mr. Uslander and Mr. Salkind have testified about penalties with respect to pension plans and how they work.

You make the statement that ERISA had introduced a series of excise tax penalties to insure the proper handling of pension plan assets—to prevent abuses of the few businesses that might be wanting to use pension plan assets for their own use.

I think that was part of the notion that we had when we put serious penalties into the law. But it was more than just a penalty against the fiduciary—we enacted more than that, in my opinion.

We are not trying to put an excise tax on you and the distribution of these excess assets.

The purpose of such penalties is also to reduce the possibility of funds being claimed and used by the employer for nonpension purposes. That is a very strong aspect of the system we have today.

My question to you is specifically, is it the individual or any person individually that's going to be responsible for these excise taxes? Is the individual—is the fiduciary himself—going to be held responsible for it?

Mr. USLANDER. Well, I think it depends on the nature—on what the violation is—what was he after.

What we meant by ERISA originally putting in excise taxes for two reasons, one which was the one that you mentioned, was really geared toward prohibited transactions.

The other one that we mentioned, to prevent or make people comply with the minimum standards that ERISA entered into is really the one on employers.

ERISA didn't really impose excise taxes on individuals other than in their fiduciary capacity. The imposition of excise taxes on individuals has really come since ERISA with the limitations on what you can take out of a plan, how much you can take out of a plan, how little you have to take out of a plan, those kinds of things.

But, to answer your question, if it is a prohibited transaction, and if there is an excise tax that results from it, and if the fiduciary is an individual, it would be imposed on that individual.

Chairman PICKLE. My question was what kind of civil tax penalty would be applied personally to these pension actuaries or consultants in a fiduciary capacity? Would they be held personally liable under it as a statutory adviser in a fiduciary capacity? So, that is going to be a question that we are going to have to consider further, particularly now that we are looking into the distribution of any plan assets.

But that is just one of several problems that we are going to be faced with. I can understand why each one of your groups, particularly you representing the representing bigger side, would want to have a more fair and effective penalty system.

We hope we can come up with some kind of recommendation. We will be visiting with some of you individually and in a group as we go along just to get a reaction because we don't have any set plan in mind.

But we are going to try to advance some kind of recommended plan though to the extent that you can give us any additional information or cooperation. We would appreciate that.

I don't think I have any other questions.

Do you have a question?

Mr. FLIPPO. Mr. Chairman, I just want to briefly ask if—I am sure you heard the testimony of Mr. Swain and the SBA this morning perhaps about the error rate of assessments, penalties being assessed against businesses. And the figure of 37 percent was used.

And I just wonder if any of you have any thought about any evidence to support that, or do you think that error rate is in the ball game? Or do you have any evidence that would corroborate the findings of the SBA survey about those, the frequency of those penalties assessed?

Mr. BURTON. We have surveyed our membership on the penalty issue, and there is a very high degree of error rate among penalty notices, particularly computer generated penalty notices.

The survey we have done is of a couple hundred small businesses. It is obviously not very large or scientific. And I don't recollect offhand the precise percentage, but it is approximately 40 percent or thereabouts, and I'd be glad to get out the actual data afterwards of the notices that ultimately were abated because they were erroneous.

Mr. FLIPPO. Mr. Schneier?

Mr. SCHNEIER. We haven't done any surveying of the membership. We did receive a large number of letters from NFIB members, sort of a, you know, giving examples.

I guess the most documented situation is the General Accounting Office study which was released recently on IRS Service Center needs to improve handling of taxpayer correspondence.

Mr. FLIPPO. That is certainly true.

Let me ask you if you detected any difference in geography about the applications? Any areas assessed more frequently than others? Did you detect any geographic——

Mr. BURTON. I haven't actually.

Mr. FLIPPO. Do you have any ideas that maybe large corporations with corporate counsels would be more or less likely to have these abatements than small businesses?

Mr. BURTON. Yes. In our survey results, large corporations were much more likely to get their penalties abated.

Mr. SCHNEIER. It's certainly more likely that a counsel for a small business owner would say that anything under $300 is not worth going to fight because it is going to cost you more for my time. And we have had several of our members, who are CPAs, mention that.

Mr. HUARD. I think another factor on the abatement issues is that, as I think one of the ABA witnesses mentioned, some of these penalties at the agent level are applied mathematically. The substantial understatement penalty, they just bop the 25 percent on you. And if you are not inclined to fight, you just pay.

And I think what happens is the larger companies with internal tax staffs routinely take these things up on appeal and, you know, what's happened on appeal is that they become negotiating clubs. The Service will say we'll drop the 25-percent understatement penalty if you drop your legal theory, and so on.

Mr. FLIPPO. I would just say that in regard to the 403(b), lack of regs being published in February of 1988, as they were supposed to be, I concur that we shouldn't be requiring these things prior to—

especially when the tax law required IRS to publish those, I believe.

Mr. **Salkind**. Well, again, as I say, I am not being harsh on IRS. I worked there for 4 years, and I am impressed with the current people in the pension area. They are making a good faith effort, but I think they have been given a job that really can't be done, and that, in all fairness, that we should have delayed effective dates.

Mr. **Flippo**. I think you know that in the chairman's mark of the technical corrections bill, I believe, is a delay on 403(b).

Mr. **Salkind**. I did see that, and I would encourage that.

Mr. **Flippo**. I was pleased to encourage that.

Also in regard to the 70½ payout areas, I think in 457, our chairman here was very active.

Mr. **Salkind**. Well, we were very encouraged to see that and would hope that that would be expanded.

Mr. **Flippo**. Well, perhaps we'll pass it one day.

Thank you, Mr. Chairman.

Chairman **Pickle**. Again I thank you all.

We will be probably holding at least one other hearing on this question. We will be anxious to get from the Internal Revenue Service what their specific recommendations are. We also intend to get the recommendations from the CPA groups, and we also will be receiving a report, we hope very soon, from the GAO who has been auditing some of the IRS practices, sort of looking over their shoulders.

But, as all of these come to a head, and we proceed, we will be back in touch with many of you.

So the Chair wants to thank you for your help and appreciate your forbearance and staying with us to the end.

[Whereupon, at 1:56 p.m., the hearing was adjourned.]

[Submissions for the record follow:]

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

COMMISSIONER

RECEIVED
SEP [illegible] 1988
Ways and Means
Subcommittee on Oversight

SEP 22 1988

The Honorable J. J. Pickle
Chairman, Subcommittee on Oversight
U. S. House of Representatives
1105 Longworth House Office Building
Washington, DC 20515-6350

Dear Mr. Chairman:

I have enclosed IRS' comments on the report entitled "Survey of Erroneous Penalties Imposed by IRS Relative To Employment Tax Returns" which was discussed by the Small Business Administration (SBA) witness at your July 28 hearing on the civil penalty provisions contained in the Internal Revenue Code. We would appreciate having these comments included in the official hearing record.

As you are probably aware, we concur with the Small Business Administration's overall objective of improving the administration of employment tax penalties. However, we are very concerned that Brown Associates research does not provide a reliable basis for the estimates and recommendations presented in the survey. In the enclosed comments we provide a summary of our concerns and observations, concluding with IRS responses to the SBA recommendations. These comments were communicated to representatives from SBA when the survey results were informally considered in May. If you need any additional IRS input, please let us know.

With best regards,

Sincerely,

Michael J. Murphy
ACTING

Enclosure

cc: The Honorable James Abdnor

Comments of the
Internal Revenue Service
on
Small Business Administration
Survey on Erroneous Penalties

Executive Summary -- SBA Survey on Erroneous Penalties

The Office of Advocacy, U.S. Small Business Administration (SBA), contracted for a survey of small businesses concerning erroneous employment tax penalties imposed by the IRS. We have reviewed the survey methodology, the conclusions inferred from the responses, and the recommendations. We are amenable to many recommendations in the survey as we have independently reached some of the same conclusions through our own studies.

However, the SBA Survey as conducted does not provide a reliable basis for its conclusions. In addition to the low response rate and less than neutral approach taken in the questionnaire, the listing used in the mailout was only partially representative of business establishments. The survey firm itself admits to a large number of "listing defects". Further, it can be demonstrated from a sample of nonrespondents taken as part of the study that nonrespondents would report differently than respondents. The report itself states that it is not valid to assume that nonrespondents were similar in characteristics to the survey respondents.

Another problem with the report that results in misleading conclusions is the general inference that penalties abated are entirely attributable to IRS errors. Penalties are often abated if a taxpayer has erred and can demonstrate reasonable cause. Additionally, the legislative proposal to reimburse taxpayers for out-of-pocket expenses incurred when a request for an abatement is granted can be supported by only one response from the survey.

The IRS has taken action to improve the internal procedures for assessing FTD penalties. We have undertaken a number of quality improvement projects since 1985 specifically aimed at the administration of the federal tax deposit system, our responses to requests for adjustments, and our approach to customer service. Many of these quality initiatives are beginning to show results. We note a reduction in the number of errors by both IRS and by taxpayers. The latest figures for 1987 reveal an employment tax abatement rate of 16.8%, with an FTD penalty abatement rate of 14.9%, down from the 1986 employment tax abatement rate of 24.9%,with an FTD penalty abatement rate of 36.2%.

The IRS concurs that the quality of taxpayer assistance needs improvement. Although we already have several taxpayer assistance programs and publications in this area, IRS is currently expanding its taxpayer outreach programs to continue our improvements in taxpayer correspondence.

The attached summary represents specific comments on the survey methodology and findings, followed by IRS responses to the the recommendations made in the SBA survey. Many of the actions included in the summary are the result of the quality improvement projects undertaken to improve IRS' administration of the employment tax system. Most have been implemented since the SBA survey was conducted and are not reflected in the survey findings.

Specific IRS Comments on Survey

Methodology of Survey

The report recognizes that there were many limitations with the data that were compiled for the survey, such as defects in the population from which the sample was selected. After reviewing the methodology of the survey, we feel the survey was not representative of small businesses and that the percentages quoted are invalid for general conclusions:

(1) The sample frame used in the survey is not representative of the total small business employer population. While it was stated that there were only two files suitable for the initial mailout, there is no discussion of their content or completeness. A comparison of the estimated number of businesses covered by the two lists with our own count of active Form 941 filers suggests that the two lists do not adequately include the universe of Form 941 filers. (The total business population for the survey was 3 million after adjusting for "listing defects" cited in the report. Our records indicate 5.7 million active Form 941 filers.)

(2) The general assumption that the survey respondents represent the population is incorrect. In addition to the low response rate (34% if "listing defects" are adjusted for, 12% if they are not), it is likely that those taxpayers experiencing difficulties would respond at a higher rate than those experiencing no difficulties. In fact, in the subsample follow-up of no-response taxpayers, entirely different rates of penalties and erroneous assessments were found. The report itself states it is not valid to assert that nonrespondents were similar in characteristics to the respondents.

(3) Certain characterizations in the questionnaire seemed to be skewed to arouse anti-IRS sentiment rather than taking a neutral approach (e. g. the title "Erroneous Penalties Assessed by IRS Associated with Payroll Taxes".)

The report also implies that abatements of penalties consist of situations where taxpayers protest the erroneous nature of the assessment. This is not true. Abatements due to reasonable cause often occur where the taxpayer is correctly subjected to a penalty, but the IRS through administrative practice accepts the taxpayer's reason for the circumstance as grounds for abatement. The Commissioner's Annual Report includes abatements due to "erroneous" assessments, reasonable cause, and the Service's own review efforts before the bill or notice is issued.

Legislative Proposal for Repayment of Costs

The statistical findings of the survey do not justify a legislative proposal for the IRS to pay taxpayers for expenses they have incurred in obtaining an abatement of penalties resulting from errors of the IRS. (Only one out of 300 suggestions provided by the 1185 usable responses recommended repayment of costs). Our findings and experience do not support such a proposal. In fact, such a recommendation could result in making resolution of the problem more difficult.

From an administrative viewpoint, the legislative proposal is not workable in this context, because it does not consider reasons for abatement and might provide blanket relief regardless of circumstances. The term "erroneous" penalties relative to abatement of penalties has been implied by the survey as attributable solely to the IRS. The report states "in 64% of erroneous issuances, proof was offered which clearly indicated an IRS or bank error." Several kinds of proof offered were cancelled checks (48%) and employment records (5%), both of which would constitute reasonable cause to abate a penalty assessed as a result of the taxpayer completing the incorrect box on the FTD coupon. Although some abatements are due to IRS processing problems, experience has revealed that a large percentage of these abatements are due to taxpayers completing the incorrect box on Forms 8109, 941, or 940 and later demonstrating reasonable cause for the abatement.

SBA SURVEY RECOMMENDATIONS AND IRS RESPONSES

SBA Recommendation - 1

Upon receipt of a protest from the taxpayer, the IRS should place a hold on further action, such as sending more notices or allowing the account to proceed to delinquent status, until the issue is resolved.

IRS Response

Current Internal Revenue Manual instructions require a Tax Examiner to stop further action on an account when correspondence is received from the taxpayer indicating an error had been made. However, another notice may be received by the taxpayer if the taxpayer's correspondence is not processed before the subsequent notice is automatically issued. Our Quality Improvement Project on adjustments and correspondence is addressing problems in this area.

Before July 1986 (during the majority of the quarters covered by the survey), we assessed an FTD penalty based on information available when the return was filed and abated the penalty when the taxpayer provided complete and correct information. Since July 1986, the IRS has been corresponding with the taxpayer to obtain the correct information before asserting an FTD penalty. If the taxpayer provides timely information that indicates the penalty should not apply, no penalty is assessed.

SBA Recommendation - 2

The IRS should establish a Quality Control Program aimed at reducing the errors made by the Federal Reserve Banks in processing FTD monies and by the IRS service centers with respect to returns processing.

IRS Response

As a part of the FTD Quality Improvement Project, IRS has implemented the following efforts to improve processing of Federal Tax Deposit coupons (FTDs):

A. Developed a checklist which is used to track delays in processing FTDs and to identify problem FTDs as they are received.

B. Established a system to notify the Financial Management Service (FMS) when a bank has misdated customers' FTD coupons.

C. Based on an analysis of common errors, developed a guide for use by bank tellers when they initially receive and process FTDs from their customers. Frequently, bank tellers can catch errors by customers who may mark the wrong type of tax or wrong tax period. If errors can be caught at this point, it saves costly corrections and penalties later on.

D. Instituted a number of checkpoints during each stage of FTD processing which are designed to catch errors by taxpayers, banks or IRS.

SBA Recommendation - 3

The IRS should review its notices and letters to improve clarity. We suggest that the IRS conduct studies similar to the Focus Group Studies which have been conducted in recent years for the income tax returns.

IRS Response

The IRS is currently conducting a Notice Clarity Quality Improvement Project which will test various IRS notices with focus groups composed of the types of taxpayers who must be able to deal with these notices. Based on focus group comments, notices will be revised to enhance the clarity. In addition to this formal activity, the IRS solicits suggestions from its employees who work with taxpayers' responses to these notices and letters. These suggestions are considered by those functions responsible for the preparation and update of the form or letter.

We are editing Form 8109 (Federal Tax Deposit Coupon Book) instructions to simplify the language and revising Form 8109A (FTD Reorder Form) to prevent processing delays and incomplete or incompatible information.

SBA Recommendation - 4

The IRS should specify in the Notice of Penalty a specific person to contact about the problem. This person should be able to resolve the issue over the phone either on the first contact or by prompt reply.

IRS Response

A toll-free number is provided for the taxpayer to call concerning problems. However, because the notices are generated in such volume, it is not feasible to assign one individual to every notice that is generated. IRS cannot predict in advance which notices will generate questions so assigning responsibility for certain notices to individuals would make it extremely difficult to schedule workload. Also, it would be a disservice to taxpayers if the assigned individual were not available when contacted. Instead, all assistors are trained to handle these generated notices. The accounts of taxpayers who receive these notices can be researched on a computer screen by employees trained to resolve account questions.

The IRS is cognizant of the problems that may be encountered by a taxpayer who attempts to contact the IRS with questions about penalty assessments. We are currently testing a separate toll-free telephone service for account-related inquiries. If adopted after testing, this system would ensure that specially trained staff be able to handle inquiries about penalty notices by telephone.

SBA Recommendation - 5

The IRS should provide a sufficient number of toll-free telephone lines so the taxpayer does not have to wait a longtime on the line or get many busy signals.

IRS Response

The IRS has increased its toll-free lines from 3469 in fiscal year 1987 to 4359 in fiscal year 1988, with additional employee staffing for the telephone lines. Our records indicate that during the 1988 filing season, 85% of all callers reached the IRS on the first or second try.

SBA Recommendation - 6

The IRS should issue a warning statement instead of a penalty if the taxpayer has not had a penalty asserted for the same reason within the last three years.

IRS Response

To ease the transition for taxpayers who are subject to new deposit rules for the first time, Form 941, "Employer's Quarterly Federal Tax Return," provides taxpayers with an opportunity to indicate that they are subject to the three-day deposit rule for the first time. If the taxpayer marks the appropriate box on the form, the account will be assigned for a manual review and employment tax penalties will not be assessed if the taxpayer makes the deposit by the 15th of the following month.

Warning statements for first-time offenders have been used for newly enacted penalties and penalties are often abated if the taxpayer makes a mistake because he did not know the new rules.

The IRS Commissioner's Penalty Study is currently analyzing all Internal Revenue Code penalties to determine how the IRS is administering these penalties. The study may result in the recommendation to eliminate, consolidate, or recalculate certain penalties.

SBA Recommendation - 7

The IRS should be more speedy and thorough in its replies to taxpayers. Better trained and supervised personnel are needed in the units that handle replies from taxpayers.

IRS Response

The IRS specifies required time frames for responding to correspondence from taxpayers. If specific answers are not available within the time required, an interim response is sent. There are also several recent quality improvement initiatives currently aimed at reducing the number of employees supervised by each manager and improving the training for IRS employees, specifically in the adjustments/correspondence area that handles taxpayer inquiries.

SBA Recommendation - 8

The IRS should provide taxpayer educational material relative to employment returns and FTD requirements. This material should be in non-technical language and should not include material which is unlikely to apply to small businesses.

IRS RESPONSE

The Taxpayer Service Division has offered targeted education and information services to small businesses for many years. Presently, this division is extending the scope and variety of materials in response to the increase of new small businesses and the awareness by the Service that business persons need to know more about their rights and responsibilities. There is a variety of taxpayer education programs; video, audio and print materials; and projects underway to develop and distribute creative products to make business tax information even more available and accessible to the small business community around the country. These programs and materials include:

(1) Small Business Tax Workshops: The Small Business Tax Workshop provides business taxpayers with a broad overview of their rights and responsibilities. Taxpayer Education Coordinators (TPECs) in the districts develop liaisons with governmental agencies, trade and community groups. Workshops jointly sponsored by the Small Business Administration, Social Security Administration, Immigration and Naturalization Service, County Extension Agents, state departments of revenue, local taxing bodies, and others facilitate "one-stop shopping." Potential participants get information about the availability of the workshops through publicity by the sponsors. In addition, district offices provide workshop brochures and applicants for Employer Identification Numbers receive brochures from Service Centers. Telephone Assistors at the Toll-Free sites send brochures to people who ask questions related to small business. Revenue officers also alert taxpayers to the availability of the program. TPECs conduct "Industry Days" for small businesses and attend trade fairs and association conferences to alert the small business community to the workshops. During FY 1987 and the first eight months of FY 1988, the IRS conducted over 3,300 workshops, serving almost 90,000 participants. Small business people who are unable to attend a session can obtain "Your Business Tax Kit," a packet of forms and publications tailored to sole proprietorships, partnerships, and other small businesses.

(2) Strengthening Voluntary Compliance - Strategic Initiative No. 11 (SVC-11) Expand Tax Education of Self-Employed Taxpayers: Since FY 1986, the Taxpayer Service Division has coordinated the implementation of recommendations that were developed by a multi-functional task force made up of representatives from government, business, and accounting organizations. As a result, the Service has begun a major pilot project in cooperation with 24 community colleges across the nation to conduct workshops and seminars this fall for self-employed taxpayers. These colleges have also formed the Community College Tax Education Network to share ideas on marketing and implementation. This pilot program includes nine stand-alone tax workshop modules that cover tax related topics in depth. The Modules include texts, workbooks, study guides, instructor's guides, overheads, videotapes and other tools. The colleges will offer credit and non-credit courses, seminars and workshops, or integrate the materials into existing curricula. Topics include Business Assets (Depreciation, Investment Credit and Selling Depreciated Property), Business Use of the Home, Employment Taxes, Excise Taxes, Recordkeeping, Schedules C and SE and Form 1040-ES, Self-Employed Retirement Plans, Partnership, and Tip Reporting and Allocation Rules. Upon successful completion of the pilot program later this calendar year, the Service intends to offer the modules to all colleges and other institutions.

(3) Community Outreach Tax Assistance: In these Tax Seminars, IRS employees and volunteer instructors provide information to groups with common interests such as trade groups, associations and business clubs, as well as to individual taxpayers. Approximately 17,500 sessions were held through May of 1988, assisting over 900,000 taxpayers. Sessions for businesspersons cover topics such as Information Returns and Magnetic Media Reporting, Electronic Filing, Business tax law, and other subjects that deal with the responsibilities and obligations of small business taxpayers. In addition IRS specialists teach Practitioner Institutes, which cover changes in the laws and update practitioners on regulations and IRS procedures, especially those that impact small businesses.

(4) Federation of Tax Administrators (formerly National Association of Tax Administrators (NATA): After receiving joint federal-state reports on successful pilot projects to better inform and educate taxpayers in seven states, FTA passed a resolution during their annual conference in June 1988 that encourages all states to work closely with IRS district offices to increase and enhance "one stop shopping," particularly for small business taxpayers. Follow-up work is now underway to build and improve these relationships.

(5) Print and Electronic Information Products: Public Affairs Officers (PAOs) provide taxpayer information materials to the media. Packages containing news releases, fact sheets, and question and answer columns are prepared which give both general and specialized media information on a variety of topics of special interest to the small business community. The Tax Supplement and various specialized clipsheets provide camera ready articles and special information for use by the print media and others such as trade associations. Clipsheets, such as the one entitled "Agricultural Clipsheet", contain articles designed to reach specialized readers such as farmers and ranchers. Electronic products include a half hour videotape called "Hey We're In Business" that describes problems encountered when starting a business and discusses good recordkeeping, tax deadlines, and free IRS assistance. Four new specialized films aimed at business are being produced later this year for day care providers, fishermen, farmers, and medical personnel to help them understand and comply with their tax responsibilities.

Throughout the year, radio and television vignettes, and video news releases are produced that are targeted primarily at small businesses and the self-employed. These include pieces on estimated tax, Form 1099 requirements and others. A PBS-IRS Tax Clinic which aired in early February, featured a segment on small business tax information. The television call-in series on the Learning Channel, the national radio call-in show with Bruce Williams, and many local call-in shows include segments oriented to the small business taxpayer. A weekly business tax information show will begin airing November 14, 1988 on the Financial News Network. This will feature IRS specialists and industry representatives offering tax information for the small business and investment community. Interview shows with specialized tax information for the small business community were featured on the Food Business Network. Local PAO's also publicize and market print and electronic products in Spanish to small business groups, where appropriate.

The following publications are revised annually and are geared to small business.

PUBLICATION	TITLE
225	Farmer's Tax Guide
334	Tax Guide for Small Business
509	Tax Calendar for 1988
533	Self-Employment Tax
535	Business Expenses
539	Employment Taxes
583	Information for Business Taxpayers
587	Business Use of Your Home
595	Tax Guide for Commercial Fishermen
911	Tax Information for Direct Sellers
916	Information Returns

Also Publication 921, Explanation of the Tax Reform Act of 1986 for Business, was developed to explain provisions of the Tax Reform Act to help small businesses.

Our collection function has several initiatives under way to improve the service to small businesses. They are jointly conducting a task force with the SBA to establish a permanent procedure for educating new business taxpayers about their responsibilities as employers under the tax laws and to help promote voluntary compliance.

SBA Recommendation - 9

An administrative tolerance of several days should be used in determining whether a Federal Tax Deposit was made in a timely fashion.

IRS Response

Administrative tolerances are not disclosed to the public. Disclosure would, in effect, result in an automatic extension of the deposit requirements. More importantly, an administrative tolerance as to timely payment is inconsistent with Congressional intent to accelerate FTD payments.

This Congressional intent for the acceleration of FTDs is evidenced by recent legislation. The Railroad Retirement Solvency Act of 1983, P.L. 98-76, for example, required railroad employers to deposit railroad retirement employment taxes on the same schedule applying to nonrailroad employers, for purposes of depositing social security and income taxes. Approximately 95% of the taxpayers affected by this change were small businesses. The Committee noted that while the authority to effect these changes already existed with the IRS, the changes would be made no later than January 1, 1986.

Another example of Congressional intent was demonstrated in the Omnibus Budget Reconciliation Act of 1986 (P.L. 99-509). Effective for wages paid after December 31, 1986, State and local government employers were placed under the same frequency schedule for deposits of withheld income taxes, as private-sector employers. This same Act increased the penalty for failure to comply with deposit requirements from 5% to 10%, thus communicating an exigency for monetary funds and Congress' desire to speed up tax payments.

SBA Recommendation from Testimony - 10

IRS should consider consolidating Form 940 and 941.

IRS Response

We appreciate this recommendation as we constantly endeavor to simplify our forms in an effort to reduce paperwork and errors. There are certain problems with this suggestion. The Form 941 is a quarterly return and the Form 940 is an annual return. The preparation of Form 940 is contingent on state unemployment factors that are not available until later in the year. Late production of the Form 940 would delay production of the Form 941 for the last quarter of the year.

A Avery & Co
Certified Public Accountants

August 8, 1988

Robert J. Leonard, Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
Room 1102 Longworth House Office Building
Washington, D. C. 20515

Dear Counsel Leonard:

This letter is submitted for inclusion in the printed hearing record on your study of the civil penalty provisions of the Internal Revenue Code. My viewpoint is that of a tax partner in a local firm of certified public accountants. I have been a tax practitioner since 1963.

Much has changed since 1963, especially in the areas of tax administration; penalties and sanctions; and the decreasing level of voluntary compliance. I believe that the three areas are closely related. There is a widespread perception in this country that the Internal Revenue Service is unfair to taxpayers.

Penalties, by their very nature, are cast in the form of punishments and the IRS uses them to spread fear in the minds of taxpayers. In addition, the Service has been using the penalty provisions to increase the revenue from audits and other compliance actions. This has a negative effect on voluntary compliance. This is followed by Internal Revenue Service lobbying with Congress for more penalties to "close the compliance gap". The IRS creates the problem, then asks Congress to cure it by increasing penalties.

Currently, I represent a taxpayer couple who are being audited by the Spokane, Washington, Field Audit Division of the IRS. During the audit, the auditor, Ms. Laurie Holthaus, assured the taxpayer that "no penalties would be assessed" on the audits of 1985, 1986 and 1987 returns. The auditor also advised the taxpayers not to hire a CPA to represent them "because it's not needed".

When the taxpayers did hire our firm to represent them, the Supervisor, Mr. Robert Butler, had Ms. Holthaus rewrite the audit report and assess over $500 of "Negligence Penalties". Ms. Holthaus had told the taxpayers that honest mistakes did not cause any penalties and none would be assessed.

When I asked Mr. Butler and Ms. Holthaus about the penalties, Mr. Butler said that he had received an internal memo that "The penalties are on the books, so use them". As supervisor, he ordered Ms. Holthaus to assess the penalties, even though she promised "No Penalties" to the taxpayers.

Our clients think they were punished because they hired a CPA firm to represent them. Ms. Holthaus had promised to revise the report and eliminate some "preliminary" adjustments. This would have reduced the taxes due from the audit. However, after we were hired, the promised adjustments did not occur.

This is not an isolated case. As tax partner, I spend much of my time dealing with IRS agents, auditors, collectors, supervisors and problems resolutions' officers. Over the twenty-five years of my tax experience, I have seen the attitude of the Service change from:

Then:	"We want to be right and fair to all taxpayers, and also to protect the revenue, but within limits", to
Now:	"We protect the revenue, period".

The tax revolt of the 70's and 80's is not dead. It's just sleeping. Now is the time to make changes to put it to sleep permanently. The new commissioner seems to be moving in the right direction. The Congress can help him and all Americans by taking steps to make the tax code and tax administration more fair to all taxpayers.

Sincerely,

A. AVERY & COMPANY, CPA's

Anson Avery, CPA

Anson Avery, CPA
Tax Partner

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August 26, 1988

The Honorable J. J. Pickle
Chairman, Subcommittee on Oversight
Committee on Ways & Means
U.S. House of Representatives
1105 Longworth House Office Building
Washington, D.C. 20515

Re: Statement for the Record on Study of Tax Penalties

Dear Mr. Chairman:

On behalf of Coopers & Lybrand, I commend the effort your Subcommittee has undertaken to review the civil penalty provisions in the present tax code. Your review has focused the attention of the Internal Revenue Service and other tax professionals on the issues involved and the long overdue need for improvement in the structure of the penalty system and coordination among the various penalties.

The tax writing Committees last examined the overall tax penalty structure in the process of enacting TEFRA in 1982, and that review was far from comprehensive. My lasting recollection of the experience is that the Committees learned that not enough was known about penalties--What are the standards for a good penalty? What sorts of penalties are most effective in deterring noncompliance? What is appropriate punishment to achieve a deterrence effect?

Given the imperfect state of knowledge at the time, the goal became to do no harm. More than a few observers may argue that the objective was not achieved, but the Committees and their staffs did begin to identify the right questions. Since the adoption of TEFRA, I think all would agree that, while our collective knowledge about penalties has expanded, the statutory scheme has deteriorated. Penalty rates have been increased merely to raise revenues. The fraud and negligence penalties have been complicated. The interest rate provisions on overpayments and underpayments are now unequal between the government and taxpayers. All these changes have the same basic motive--revenue. There is no new objective evidence that supports them on the grounds that better compliance will result. In fact, taxpayer perceptions of governmental motives may have become so callous as a result of these actions that compliance may actually have suffered.

Today, given sufficient interest and dedication of resources by Congress, the IRS, and the tax profession, we should be able to make real improvements in the tax penalty structure. We at Coopers & Lybrand would suggest that an appropriate goal is a penalty system that is efficient in discouraging and punishing noncompliance, that can be readily administered by the Service, and that is perceived by taxpayers as even-handed and generally fair. Such objectives are not easily or quickly achieved and thus any progress in achieving these objectives should be applauded and counted a success. More time is needed because as much attention needs to be given to the administration of penalties by the IRS as to the penalty structure itself. Thus, once the "best" structure is in place, only half the job is complete. In prior testimony before your Subcommittee, both the IRS and the General Accounting Office acknowledged this dual need.

As the Oversight Subcommittee Chairman, you and the other members of the Subcommittee, and your staff, are well aware that attention needs to be devoted to internal IRS processes for:

- initial imposition of penalties,
- internal review of the decision to impose penalties,
- communication of those penalties and the reasons therefore to the taxpayer,
- procedures for the taxpayer to protest or appeal penalties independent of the underlying tax liability, and
- final disposition of cases and collection of statistics for study and research.

There are plenty of opportunities for the present process to go amiss. The Service's job is made doubly hard when the law imposes penalties perceived as unfair by taxpayers. By the same token, much harm can be done to taxpayer relations when Service personnel or procedures operate in a way that is perceived as abusive, unfair or arbitrary. The status quo is replete with examples of both types of system failures.

Because most of the testimony before the Subcommittee to date has been to evaluate the penalty structure of the statute or to suggest criteria for its reform, we think it would be useful to bring to your attention the other side of the equation--a penalty system gone awry because of a failure of IRS personnel and/or procedures. In a particularly egregious, recent case described below, an appellate conferee exacted, as a compromise, a portion of a substantial underpayment penalty that was not owed by the taxpayers. They paid, as the conferee knew they would, to avoid the costs of litigation.

> Our clients, Mr. and Mrs. G, were assessed a substantial understatement penalty which arose because of the disallowance of a casualty loss deduction taken on their 1982 federal income tax return.
>
> The additional tax resulting from the disallowance and the interest due on the tax were paid in 1986. The reason for conceding the tax issue was motivated in part because our clients wanted to use the interest payment as a deduction against the 1986 top bracket of 50%; it further allowed them to deduct 100% of the interest paid. Thus, the only outstanding issue was the existence of a penalty.
>
> The IRS issued its 30-day letter in March 1987 for the full amount of the substantial understatement penalty, plus interest on the penalty. The responding protest set forth a complete defense, namely that in compliance with Internal Revenue Code §6661(b)(2)(B)(ii) "the relevant facts affecting the item's tax treatment..." were "adequately disclosed in the return or in a statement attached to the return." Mr. and Mrs. G had filed Form 4684 with their 1982 return and had also attached a statement describing their casualty loss.
>
> At the appellate conference, the conferee stated that adequate disclosure had been made. Such disclosure was a good defense to the penalty and would be sustained if the issues were litigated. The conferee felt, however, that the IRS was entitled to something because of the egregious nature of the asserted loss and because of the lack of cooperation shown by the clients' prior accountants during the audit.
>
> The conferee suggested a compromise--reduction of the 25% penalty to 5% and computation of interest on the penalty from a starting date later than the due date for the 1982 return.

> He pointed out that the dollar amount of the compromise was less than estimated legal fees if the penalty were litigated. Because his logic was correct, our clients were advised to accept the settlement. Thus, the IRS successfully exacted a penalty in the face of contrary explicit statutory language.

We do not believe this instance is an isolated case or we would not raise it. We are also concerned for the future. As the Service starts to stretch the boundaries of what is "substantial authority," more penalties will be asserted, and more taxpayers could be intimidated into settling and paying a penalty they do not owe under the standards of the statute. The costs of litigating have become so high that it is often not economical to do so, no matter what the equities are.

In another case that occurred very recently, the IRS sent a 30-day letter disallowing two deductions on a 1977 return. While the 30 days were still running, during which a taxpayer may request an appellate review, the IRS sent the 90-day letter, a Notice of Deficiency, which must be contested by filing a petition with the Tax Court. Our clients felt very abused by this action, in part because they had earlier consented to extend the statutory time to assess tax as a means of keeping their case within the IRS. Now they are effectively precluded from pursuing administrative remedies and must go to court, given the untimely issuance by the IRS of the 90-day letter.

Again, these cases are significant only to the extent they demonstrate that the entire problem is not with the statutory structure. The administration of the penalty system is equally important and deserving of attention. It might be very instructive, for example, to conduct a survey, independent of the IRS, examining taxpayers' experiences with the penalty process and their resulting attitudes. GAO suggested that a similar approach was necessary to evaluate the Service's performance in this area. We would note also that these sorts of problems suggest that Congress should emphasize keeping it simple. The more complex the structure, the more subjective the standards, and the existence of many different standards bodes ill for achieving the ultimate goal set forth earlier.

Finally, our experiences suggest that the Subcommittee could constructively consider the process of imposing and appealing penalties within the IRS. Should there, for example, be a group independent of audit and appellate that reviews penalties and settlements for consistency, fairness, proper application of the law and administrative standards? Such a group might go far in providing taxpayers a fair forum short of Tax Court, and in providing the leadership in the IRS with an objective barometer on how the penalty system is working. Your review of these sorts of process issues may find support for the position that broad waiver authority should be delegated to the Commissioner.

Thank you for the opportunity to comment on your efforts. If we can be of further assistance, please do not hesitate to call on us at (202)822-4239.

Sincerely,

Pamela J. Pecarich

Pamela J. Pecarich
Director for Tax Policy

DeMera-
DeMera
Cameron
A Professional
Accountancy
Corporation

August 18, 1988

Robert J. Leonard, Chief Counsel
Committee on Ways and Means
U. S. House of Representatives
Room 1102
Longworth House Office Building
Washington, D.C. 20515

Re: Civil Penalty Provisions of the
Internal Revenue Code

Comments for inclusion in the printed hearing record

PAYROLL TAX PENALTIES

Penalties affecting businesses are excessive and burdensome. Small businesses often do not have the ability to know the entire tax law or even a small part of it at all times. An employer may have a few employees whose payroll withholdings require him to deposit the taxes withheld on a monthly basis. Subsequent hiring of an additional employee, overtime, or extra salary payments cause him to be required to make more frequent deposits of taxes. The IRS regulations allow an exception for first time depositors of taxes to avoid the penalty. The employer generally relies on his bookkeeper to make these deposits. If the bookkeeper fails to take the changed deposit requirements into consideration, the business has no redress to abate the penalties, even if the failure to deposit is corrected within days of the deposit date. The penalty is the same whether the deposit is one day late or one month late.

The penalty for failure to deposit should be allowed as a business deduction if it is left at the present punitive rate or changed to an amount more closely following the interest rate charged on underpayment of tax.

INFORMATION REPORTING PENALTIES (FORM 1099)

Information returns are required for a variety of business transactions. The government continues to expand the number of situations which require these forms. The penalty for failure to file has been increased from $1 to $50 during this decade. This burden has been added to businesses during the month of January. Congress has also seen fit to require a substantial number of businesses to change to a December year end, thus increasing the amount of record keeping that must be started in January.

Small businesses, such as a landlord with a rental house, often are not aware of the filing requirements for information returns. When they bring their information to the accountant in March, the requirement for filing an information return is discovered. Since the February 28 filing date has passed, the filing of the form will incur the automatic $50 penalty.

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The type of payment on an information return of a small business is not likely to be the sole source of information for the recipient. The recipient is generally a repairman or professional person who does business with many people. The recipient may not get information returns from all his customers because the service provided did not exceed $600, the sale was to a non-business entity, or the sale was for merchandise. Whatever the reason, the recipient rarely relies on the Form 1099 as a sole source for reporting income. Timelyness for most Form 1099's is not necessary to prepare an accurate income tax return.

The time for filing information returns should be changed to April 30 as a means of creating greater compliance with the purpose of the law. As I understand the purpose of the information return, it is to create a match against a previously filed income tax return to detect unreported income. Since the CP 2000 program is always one year behind, the two additional months filing time should not hinder the IRS matching program.

The penalties for failure to file information returns should not apply until May 1 to give small businesses a greater opportunity for compliance through the use of their accounting professionals.

A meaningful compromise would be to allow an automatic extension for filing information returns to April 30 if electronic filing is used and at the same time allowig a one dollar credit for all information returns filed by January 31 using electronic filing.

Tax laws should be written with a view of easy compliance. The author of tax laws should understand that the reading level of the average person means that the other half of the population, which is below average, doesn't understand what was written. Congress' obsession with complexity will force more people to use professional help. Tax administration should not force arbitrary due dates in light of the true purpose of the law.

I urge a subtantial reduction in the penalties relating to, and a lengthening of, the filing period for information returns.

The comments contained in this letter represent the view of the writer and not of the firm.

John B. Houlihan, C.P.A.

Craig M. Horn, C.P.A.

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August 16, 1988

GCD-2752

Mr. Robert J. Leonard
Chief Counsel, Committee on Ways and Means
U. S. House of Representatives, Room 1102
Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Leonard:

In response to the upcoming review of the civil penalty provisions of the Internal Revenue Code, clarification of civil penalty deductibility should be considered.

The legislative history behind the enactment of IRC Section 162(f) (Tax Reform Act of 1969) does not appear to be properly reflected by Regulation 1.162-21. In fact, the Courts have frequently addressed this inconsistency (Southern Pacific Transportation Co., 75 TC 497 (1980); True, Jr. v U.S., D.C. Wyoming (86-1 USTC 9193)).

Regulation 1.162-21 appears to disallow deductions for all civil penalties, which was apparently not the intent of Congress:

> "...it was not intended that deductions be denied in the case of sanctions imposed to encourage prompt compliance with the requirements of law. Thus, many jurisdictions impose penalties to encourage prompt compliance with filing or other requirements which are really more in the nature of late filing charges or interest charges than they are fines. It was not intended that this type of sanction be disallowed under the 1969 action [Senate Report No. 92-437, Revenue Act of 1971].

Specifically, IRC Section 6655 additions to tax (relating to underpayments of estimated tax) appear to be deductible under the intention of Congress, yet Regulation 1.162-21 denies deductibility.

Attached is a more detailed discussion of the legislative history of IRC Section 162(f) along with an analysis detailing the deductible nature of IRC Section 6655 additions to tax.

The opportunity to submit this data is greatly appreciated.

Sincerely,

Benny J Phillips

B. J. Phillips

Issue

Deductibility of additions to tax under IRC Section 6655

LAW RELIED UPON

Code section 162(a) allows a deduction for "... all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business ...".

The Tax Reform Act of 1969 added section 162(f) which states that "no deduction shall be allowed under subsection (a) for any **fine or similar penalty** paid to a government for the violation of any law [emphasis added]".

The Senate Finance Committee in developing its version of the Tax Reform Act of 1969 (Senate Report No. 91-552) made the following statement:

> "First, the committee amendments provide that no deduction is to be allowed for any fine or similar penalty paid to a government for the violation of any law. This provision is to apply in any case in which the taxpayer is required to pay a fine because he is convicted of a crime (felony or misdemeanor) in a full criminal proceeding in an appropriate court. This represents a codification of the general court position in this respect."

The House-Senate Conference Committee subsequently issued the following report relating to the final version of the 1969 Act:

> "The Senate amendment codifies court decisions that deductions are not to be allowed for fines or similar penalties paid to a government for the violation of any law ... The conference substitute (sec. 902 of the bill and sec. 162(c), (f), and (g) of the code) follows the Senate amendment."

Following the 1969 enactment of section 162(f), the Internal Revenue Service issued proposed regulations on May 27, 1971. The regulations suggested that all fines and penalties, whether criminal or civil, were not deductible.

The Senate Finance Committee, in reporting on the Revenue Act of 1971, commented on the proposed regulations and attempted to clarify the legislative intent behind section 162(f). They stated in part:

> "In connection with the proposed regulations relating to the disallowance of deductions for fines and similar penalties (sec. 162(f)), questions have been

> raised as to whether the provision applies only to criminal 'penalties' or also to civil penalties as well. In approving the provisions dealing with fines and similar penalties in 1969, it was the intention of the committee to disallow deductions for payments of sanctions which are imposed under civil statutes but which in general terms serve the same purpose as a fine exacted under a criminal statute. The provision was intended to apply, for example, to penalties provided for under the Internal Revenue Code in the form of assessable penalties (subchapter B of chapter 68) as well as to additions to tax under the internal revenue laws (subchapter A of chapter 68) in those cases where the government has the fraud burden of proof (i.e., proof by clear and convincing evidence). It was also intended that this rule should apply to similar type payments under the laws of a State or other jurisdiction.
>
> On the other hand, it was not intended that deductions be denied in the case of sanctions imposed to encourage prompt compliance with the requirements of law. Thus, many jurisdictions impose 'penalties' to encourage prompt compliance with filing or other requirements which are really more in the nature of late filing charges or interest charges than they are fines. **It was not intended that this type of sanction be disallowed under the 1969 action. Basically, in this area, the committee did not intend to liberalize the law in the case of fines and penalties** [Senate Report No. 92-437] [Emphasis Added]."

In December of 1972, a new proposed regulation dealing with 162(f) was issued (37 Federal Register 25936). This proposed regulation (1.162-21) explicitly allowed a deduction for amounts paid to comply with sanctions imposed to encourage prompt compliance with filing or other requirements if such sanctions are really more in the nature of a late charge or interest.

In December of 1975, the following was contained in a notice of proposed rulemaking (40 Federal Register 7453):

> "A previous notice of proposed rulemaking published December 6, 1972 in the Federal Register (37 FR 25936) contained language excluding from the definition of a fine and similar penalty sanctions imposed to encourage prompt compliance with filing or other requirements if the sanction was more in the nature of a late charge or interest than a fine. **This language has been removed because it is inconsistent with the general congressional intent in enacting**

> section 162(f) not to liberalize the law with respect to the nondeductibility of fines and penalties [Emphasis Added]."

This interpretation is now contained in regulation 1.162-21 which was filed in 1975 and states in part:

> "(b) Definition. (i) For purposes of this section a fine or similar penalty includes an amount -
> ...(ii) Paid as a civil penalty imposed by Federal, State, or local law, including additions to tax ... imposed by chapter 68 of the Internal Revenue Code ..."

There is no mention of allowing a deduction for sanctions that represent interest or late filing charges.

The 1975 notice of proposed rulemaking cited above failed to accurately convey the intention of the Senate Finance Committee's 1971 statement on section 162(f). The inaccuracy centers around the phrase:

> "did not intend to liberalize the law in the case of fines and penalties."

The Senate Finance Committee intended this to mean that section 162(f) did not apply only to criminal fines and penalties, as some had mistakenly ascertained from the 1969 Committee reports, but also to civil fines and penalties which serve the same purpose as fines exacted under criminal statutes. The 1969 Act was merely trying to codify the existing Court position in regard to this issue, and was not trying to create more leniency by allowing a deduction for all civil fines and penalties.

The statement was inaccurately reflected in the 1975 notice of proposed rulemaking and eventually in regulation 1.162-21 itself. The Internal Revenue Service determined that a deduction for any type of civil fine or similar penalty was a liberalization of the Court position at the time of the 1969 Act. This simply was not the case.

Subsequent to the enactment of section 162(f) and the filing of regulation 1.162-21, the Courts determined that blanket nondeductibility for all fines and penalties was not the intention of Congress. Upon studying the legislative history behind section 162(f), the Tax Court in Southern Pacific Transportation Co., 75 TC 497 (1980) stated:

> "We agree that the literal language of section 162(f) implies the existence of penalties imposed by law which are not within the intended scope of section 162(f) because Congress must have had some reason for including the word 'similar' in the statute. Since that reason is not altogether clear

> from the wording of the statute and since [the] regulations make no distinction between penalties based upon the word 'similar', we deem it appropriate to look to the legislative history ... Thus, Congress ... was not intending to distinguish between criminal and civil sanctions, but rather was intending to make a distinction between different types of civil penalties. If a civil penalty is imposed for purposes of enforcing the law and as punishment for the violation thereof, its purpose is the same as a fine exacted under a criminal statute and it is 'similar' to a fine. However if the civil penalty is imposed to encourage prompt compliance with a requirement of the law, or as a remedial measure to compensate another party for expenses incurred as a result of the violation, it does not serve the same purpose as a criminal fine and is not 'similar' to a fine within the meaning of 162(f) ... The statutory creation of this distinction comports with the Senate Finance Committee's announced intent to codify the existing judicial position with regard to the deductibility of fines and penalties ... This expressed congressional intent together with the judicial history on this area ... serves as convincing evidence that section 162(f), in its entirety, represents a codification of pre-existing decisional law concerning fines and penalties."

Frequently cited examples of the "pre-existing decisional law" mentioned above are Tank Truck Rentals, Inc. v. Commissioner, U.S.S.C. (58-1 USTC 9366) and Commissioner v. Tellier, U.S.S.C. (66-1 USTC 9319). In Tellier, the U.S. Supreme Court stated:

> "Only where the allowance of a deduction would frustrate sharply defined national or state policies proscribing particular forms of conduct have we upheld its disallowance."

In Tank Truck Rentals, the U.S. Supreme Court in part stated:

> "This is not to say the rule as to frustration of sharply defined national or state policies is to be viewed or applied in any absolute sense ... the test of nondeductibility always is the severity and immediacy of the frustration resulting from allowance of the deduction."

The Tax Court in Middle Atlantic Distributors, Inc. 72 TC 1136 (1979) made the following remarks subsequent to analyzing the history behind section 162(f):

> "Certainly, however, by 1972 it was clear that section 162(f) was intended to include civil penalties 'which in general terms serve the same purpose

> as a fine exacted under a criminal statute' [Senate Report No. 92-437 (1971)]. A criminal 'fine or similar penalty' is one imposed to punish and/or deter. Thus, it is clear that if the deduction of a civil fine (or similar penalty) is to fall within the proscription of section 162(f), the fine must be one which punishes and/or deters."

Expanding on the analysis in Middle Atlantic, the U.S. District Court (Dist. of Wyoming) in True, Jr v. U.S., D.C. Wyoming (86-1 USTC 9193) noted:

> "The key point it seems in determining whether or not a civil penalty is deductible turns on the nature of the penalty; that is, whether the penalty serves a purpose similar to a criminal fine or penalty. This is the view which has been expressed in the case law following the enactment of section 162(f)... Specifically, a penalty is criminal in nature and, therefore, not deductible if its purpose is to punish and/or deter, but a penalty is not criminal in nature and therefore, deductible if the purpose which it serves is to encourage compliance with the law or if it is remedial or compensatory in nature."

The cases outlined demonstrate that civil penalties or fines which are remedial or compensatory in nature are deductible and do not fall within the scope of section 162(f).

Section 6601 provides for the assessment of interest on late tax payments and exists solely to compensate the Government for the "time value of money" lost (Golden v. U.S., D.C., Wash. (84-1 USTC 9408); Grauvogel v. Commissioner, C.A., 9th Circuit (85-2 USTC 9614)). It states in part:

> "(a)... If any amount of tax imposed ... is not paid on or before the last date prescribed for payment, interest on such amount at an annual rate established under section 6621 shall be paid from such last date to the date paid."

Section 6621 determines the rate to be used in assessing interest under section 6601. This rate is based on the "average predominant prime rate quoted by commercial banks to large businesses".

Section 6655 is similar to section 6601 in that it also points to section 6621. It states:

> "(1)... There shall be added to the tax ... an amount determined at the rate established under section 6621 ..."

This common link between sections 6601 and 6655 and the fact that additions to tax under section 6655 are calculated at current market rates, supports the taxpayer's position concerning the compensatory nature of section 6655. Furthermore, unlike other penalties, additional amounts, or additions to tax levied under chapter 68, section 6601 interest is not assessed on top of an addition to tax under section 6655 (section 6601(h)). In fact, the Courts have used this analysis in determining that penalties assessed under section 6651 are nondeductible (May, 65 TC 1114 (1976)).

It appears that section 6655 is merely a temporary substitute for section 6601, and is therefore only compensating the Government for the "time value of money" lost. The Courts have held that civil penalties which compensate for lost revenues do not fall within section 162(f). In Middle Atlantic the Tax Court stated:

> "We conclude, therefore, that at all relevant times during the settlement negotiations, the United States was attempting to recover ... only reimbursement for lost revenue ... Obviously, such an intent ... does not comport with an intent to punish or deter."

The wording in regulation 1.162-21(b)(ii) contains some similarity to the previously discussed 1971 Senate Finance Committee Report (Senate Report No. 92-437), and was apparently based on such. It is therefore appropriate to look to the Finance Committee Report for a more detailed analysis of the intent behind regulation 1.162-21(b)(ii).

The Report in part stated:

> "... it was the intention of the committee to disallow deductions for payments of sanctions which are imposed under civil statutes but which in general terms serve the same purpose as a fine exacted under a criminal statute. The provision was intended to apply ... to penalties provided for under the Internal Revenue Code in the form of assessable penalties (subchapter B of chapter 68) as well as to **additions to tax ... (subchapter A of chapter 68) in those cases where the government has the fraud burden of proof ...** [Emphasis Added]."

The Government does not have the "fraud burden of proof" with respect to a section 6655 addition to tax. Subchapter A of chapter 68 contains sections 6651 through 6662. All of the sections in subchapter A, except section 6655 (and 6654 which relates to individual estimated tax), require some type of fraud, negligence, or lack of good faith in order to be enforced. A section 6655 addition to tax is imposed regardless of fault and irrespective of whether or not a taxpayer acted in good faith.

The Tax Court in May determined that a section 6651 assessment did not represent interest, and noted:

> "The penalty, unlike interest, can be avoided upon a showing that the failure to pay was due to reasonable cause and not willful neglect."

This same statement cannot be made with respect to a section 6655 assessment. In fact, "a section 6655 assessment" could be inserted in place of "interest" and the statement would remain correct.

All in all, a section 6655 assessment is different from the other assessments in subchapter A in that:

1. the assessment cannot be waived if the taxpayer acted in good faith and there was a lack of fraud or negligence, and

2. the assessment takes the place of and cannot run concurrent with section 6601 interest.

The fact that certain states treat additions to tax for estimated tax underpayments as interest further supports the taxpayer's position. For example, section 205.23 of the Michigan Tax Law states:

> "A deficiency in an estimated payment as may be required by a tax statute administered under this act shall be treated in the same manner as a tax due and shall be subject to the same current monthly interest rate of one percentage point above the adjusted prime rate from the time the payment was due, until paid [Emphasis Added]."

The Michigan equivalent (Form C-8020) of the Federal form 2220, "Underpayment of Estimated Tax by Corporations", is similar to the federal form except that the "penalty" computation section is replaced with an "interest" computation section.

CONCLUSION

It is the respondent's position that a section 6655 addition to tax does not fall within the intended meaning of "fine or similar penalty". Both legislative history and case law following the enactment of section 162(f) support this position.

Robert Leonard, Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
Room 1102, Longworth Building

August 3, 1988

Written comments for inclusion in the record of the hearing on the penalty provisions of the internal revenue code of 1986.

By deleting "loss of employment" from the exceptions to the 10% penalty tax on early withdrawals from qualified pension plans, and by removing "loss of employment" from the rules permitting 5 year forward averaging for lump-sum distributions received from qualified plans prior to age 59½, the tax reform act of 1986 unfairly penalizes the unemployed.

My own situation is a case in point. At the height of the oil price crash of 1986, I lost my job of 9 years in Alaska. Because of the astronomical unemployment rate, it took 9 months and a move to Florida for myself and my family before I was able to obtain employment. During this 9 month financial crisis, I took a lump sum disbursement of a $32,000.00 qualified pension plan in order to stay off welfare.

The pre tax reform act of 1986 tax consequence of this action would have been an additional tax of approximately $4500.00 or 14% because of 10 year forward averaging. The post tra consequence was an additional tax of $14,700.00 or 46% which includes a 10% penalty for early withdrawal of my own money. As you can see, the 46% marginal tax rate I paid was more than the highest marginal tax rate paid by people with taxable incomes in the millions of dollars. If I have ever encountered a case of kicking someone when they are down, this is it.

To make matters worse, I received inaccurate tax information from the IRS relative to this matter. It is no wonder, however, since their forms and publications explaining the new pension provisions for tax years beginning after December 31, 1986 were not available until January 28, 1988, a month after the 1987 tax year was over.

The ultimate unfairness was making these provisions effective before the IRS could reasonably implement the necessary changes and publish instructions so that the taxpayers could have a fair opportunity to plan their financial plight. If the IRS couldn't tell what was going on, how could the general public even hope to comprehend these material changes in the law ?

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Testimony by Paul Tholfsen, Director of Taxation for Moss Adams

Presented to House Ways and Means Oversight Subcommittee
Hearing on Civil Penalties

MOSS ADAMS is a regional Certified Public Accounting firm. We practice from 15 offices located in California, Oregon and Washington. Our headquarters are in Seattle, WA. We are among the twenty largest certified public accounting firms in the United States. I serve as the Director of Taxation for MOSS ADAMS. In this capacity I have been asked to inform the Subcommittee of several of our concerns.

I will comment only on two specific penalties. These are the penalties for the late filing of annual information returns by deferred compensation plans and by exempt organizations.

DEFERRED COMPENSATION PLAN - LATE FILING PENALTIES

IRC Sec. 6652(e) imposes a penalty of $25 per day, up to a maximum of $15,000 for failure to timely file the annual information return for deferred compensation plans or retirement plans as defined in IRC 6058. The annual information return is generally one of the 5500 series of forms (5500, 5500-C, 5500-R, or 5500-EZ).

None of these forms is used to report a tax due, as in the case of the normal income tax returns. Nor are they used to notify the Treasury of transactions with and income reportable by others as in the case of information returns described in IRC Secs. 6041 to 6050. In fact, for plans with fewer than 100 participants, the required form often requests little more than an annual update on the plan's administrators, number of participants, and answers to a short list of yes/no questions on the plan's operation.

Despite the apparently slender connection of these forms to the assessment and collection of taxes, the failure to timely file carries with it one of the most disproportionate and onerous civil penalties in the Internal Revenue Code. The daily $25 accrual typically reaches the $15,000 maximum, since the Internal Revenue Service rarely notifies a taxpayer that it has not received the required forms until well after the approximately 20 months required to maximize the penalty. Furthermore, many small businesses set up two defined contribution plans, doubling the penalty.

The failure to file is rarely intentional. In most cases it is either due to simple oversight, or to ignorance of the filing requirements. Many such plans have been set up on the recommendation of financial institutions. Most of these institutions recoil from the job of preparing the forms themselves. In many other cases, they have done a poor job of notifying the business owner of the responsibility for the annual filing. It is routine for our practitioners to learn, on beginning work for a new tax client, that the client is a former participant in a frozen Keogh plan, has never filed the 5500 form, and is astonished to learn that a form is required.

In prior years, it was fairly routine for the Service to abate the proposed penalty. Recently, we learn through correspondence with our firm's professionals, and with outside pension attorneys and actuaries that the Service has begun to resist abatements.

The issue is not whether late filing warrants a penalty. Clearly it does. However, the penalty should, in some way, be a measure of the gravity of the offense, or of the problems created for the Service in carrying out its mission to administer the voluntary compliance system.

The best way to illustrate the confiscatory nature of this penalty is to contrast it with some other long established penalties

For, example, suppose a taxpayer willfully defrauds the government of $20,000 of income tax. If the civil fraud penalty of IRC 6653(b) is imposed, the taxpayer would be penalized $15,000. Should we conclude that the Treasury feels that an epidemic of such civil tax fraud is of no more consequence than an epidemic of individuals neglecting to file the annual 5500-EZ form?

A better measure of the gravity of the offense is provided by the penalties which apply to the failure to file information returns which notify the Service of income earned by others. Thus, IRC 6721(a) provides a penalty of $50 for each unintentional failure to provide a report in the 1099 family of forms. Sec 6698 penalizes a partnership for late filing at $50 per month per partner up to a maximum of $250 per partner. For the small partnership with less than 10 members, and which meet certain tests spelled out in Rev. Proc. 84-35, the penalty is not imposed.

We believe that the appropriate penalty for late filing under IRC 6652(e) should be two-pronged. There should be a flat dollar penalty for late filing. This penalty should be in the range of $100. However, once the responsible party has been notified of late filing, a monthly penalty, in the range of $50 to 100 should begin to accrue, after allowing the taxpayer a month from the date of the notice to provide the necessary form.

EXEMPT ORGANIZATIONS - LATE FILING PENALTIES

Exempt and charitable organizations face a situation similar to that described above. IRC 6652(c) calls for an annual information return (Form 990) to be filed by many exempt organizations whose annual gross receipts exceed $5,000. Failure to file subjects the organization to a penalty of $10 per day up to a maximum of the lesser of $5,000 or 5% of the organization's gross receipts. Until 1986, the maximum was $5,000, irrespective of the organization's gross receipts. Rules issued under the authority of IRC 6033(a)(2)(B) have raised this threshold to $25,000. The required form is generally in the 990 family.

Although the $25,000 threshold exempts the smallest such organizations, inflation has eroded the protection. It has been our experience that many exempt organizations are large enough to be subject to the threshold, but not large enough to afford the level of tax or accounting assistance, either internally or externally, to ensure timely compliance with the filing requirement.

This penalty is disproportionate to the offense. Organizations whose gross receipts are in the range of $25,000 to $100,000 almost never have a tax to report, other than the tax on unrelated business income. In cases where income tax is due on unrelated business income, the Code already provides for the normal penalties levied against tax-paying entities for late payment of the tax, and the late filing of form 990-T.

In our judgment, IRC 6652 should be amended to raise the $5,000 threshold substantially. Furthermore, to avoid inflation erosion, the Code should provide that the threshold be automatically and periodically adjusted through indexing. Furthermore, the penalty should be a flat amount, in the range of $100 to $250, consistent with the late filing penalty for most other information returns.

Statement of National Campaign for a Peace Tax Fund, et al.[1]
August 26, 1988 - Civil Penalty Structure of Int. Rev. Code
Submitted by: Peter Goldberger, Attorney-Adviser

The National Campaign for a Peace Tax Fund and more than a dozen churches and other religious organizations appreciate this opportunity to express our concerns to the subcommittee about the structure and application of IRS penalties. Among our constituents and congregants are numerous conscientious objectors to participation in war. Many of them find that their religious beliefs require them to resist in some way not only the forced conscription of themselves or their sons, but also the conscription of their dollars to fund the one third or more of federal expenditures which today go to support a variety of military activities. They are not "tax protesters," although the IRS mistakenly labels them as such. They do not have political or economic objections to the concept of federal taxation; their concerns are religious in origin and focus upon the question of personal responsibility for the uses to which their taxes are put. Needless to say, the tax system at present does not accommodate these convictions, and although we believe it should, our testimony is not directed primarily to that point. Rather, conscientious military tax objectors who act upon their beliefs often find themselves subject to the various civil penalties of the Internal Revenue Code. It is from this experience that we offer our testimony.

Our immediate concerns lie in the same areas as those of some of this subcommittee's more "mainstream" witnesses. Until Congress or the courts see fit to accommodate them, those who are called by conscience to a witness of military tax resistance are prepared to suffer the consequences of their beliefs, out of respect for the legal order and for the freedoms this country does afford to religious minorities. We do not wish to see them suffer unnecessarily, however. We are therefore concerned with vague standards, arbitrary application of penalties, pyramiding of multiple penalties for single acts, and disproportionality. The penalties to which our constituents are most often subject, and thus to which we address ourselves below, are the nonfiling and late payment (delinquency) penalties, the disregard of rules ("negligence") and (very rarely) fraud penalties, the false withholding certificate (W-4) penalty, the penalty for refusal of levies, and the frivolous return and Tax Court litigation penalties. Of these, the frivolous return penalty has been the most onerous; we therefore address it first and in the greatest detail.

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[1] The complete list of organizations on whose behalf this statement is submitted is: National Campaign for a Peace Tax Fund (Washington, DC); American Friends Service Committee (Philadelphia); Brethren in Christ, Board for Brotherhood Concerns (Mt. Joy, PA); Christian Church (Disciples of Christ) (Indianapolis, IN); Church of the Brethren, General Office (Elgin, IL); Fellowship of Reconciliation (Nyack, NY); Franciscan Federation of Brothers and Sisters (Pittsburgh, PA); Friends Committee on National Legislation (Washington, DC); Friends United Meeting (Richmond, IN); General Conference Mennonite Church (Newton, KS); Jewish Peace Fellowship (Nyack, NY); Mennonite Central Committee - U.S. Peace Section (Akron, PA); The Mennonite Church (Elkhart, IN); National Assembly of Religious Women (Chicago, IL); Pax Christi U.S.A. (Erie, PA); Presbyterian Peace Fellowship (Nyack, NY); Unitarian Universalist Association of Congregations of North America (Philadelphia, PA); War Tax Concerns Support Committee of Philadelphia Yearly Meeting of the Religious Society of Friends.

1. Frivolous Return Penalty - Code § 6702.

The "frivolous return" penalty, 26 U.S.C. § 6702, was added to the Internal Revenue Code by the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"), applicable to returns filed after September 3, 1982. Thus, it was first generally applied to income tax returns filed in the spring of 1983. This penalty, a flat $500, applies whenever a person files what "purports to be a return," which either (1) "does not contain information on which the substantial correctness of the self-assessment may be judged" (such as a blank return) or (2) "contains information that on its face indicates the self-assessment is substantially incorrect" (such as a "war tax" adjustment). In addition to one of these two problems with the "self-assessment," the filer's "conduct" must be "due to a position which is frivolous" or to a "desire (which appears on the purported return) to delay or impede the administration of Federal income tax laws." Under the statute as written, whether a person pays the tax due, or even whether any tax is owing, is irrelevant to the question whether a "frivolous return" penalty applies.

None of the key words in this section -- such as "substantially," "self-assessment," "frivolous," or "position" -- is defined in the statute or established by general tax law. No interpretative regulations were issued (indeed, none have yet been issued), nor was there any discussion of the penalty in the publicly-available portions of the Internal Revenue Manual. There was no explanation of it in the 1982 tax return instructions. For at least three years, nothing could be said to have been well-established or clear about the proper application of § 6702, and even now the answers to these questions are knowable only to someone familiar with the case law.

It is clear from the statutory language and legislative history, that this penalty does not apply merely to a refusal to pay, nor may it be imposed for the assertion of a "frivolous position" in an attached letter, for conduct that does not affect a "return," nor to a mere statement of protest on the return itself.

The application of this penalty to conscientious war tax objectors has frequently been arbitrary and unfair. The Rev. Robert Moore and his wife, Mary Timberlake, of New Jersey, were assessed the frivolous return penalty in 1984 without any indication of the basis. The paid the $75 required under § 6703 to stay collection during the processing of their administrative appeal, which was summarily rejected, again without explanation. When they hired an attorney and pursued the matter to Court, the Justice Department Tax Division attorney asserted, for the first time, that the penalty had been assessed on account of their claim of a "war crimes deduction" on their 1981 return. When counsel pointed out that this penalty was not even enacted until 1982 and was not applicable to timely returns filed for 1981, the government offered to settle the case for a refund. The U.S. District Court, however, awarded the taxpayers $970 more for the time their attorney spent unsuccessfully attempting to get IRS to investigate and explain the imposition of the penalty, stating that since under § 6703(a) "the burden of proof is on the IRS ... when a person against whom a penalty is assessed raises a legitimate inquiry as to the justification and basis for the assessment, it should be incumbent on the IRS to respond and attempt to, if not actually resolve the matter, at least clarify any ambiguity and fully appris[e] the taxpayer of the reasons for the assessment." This story is typical, not aberrant.

Nor is IRS abuse of this penalty limited to carelessness and procedural questions of notice. Martin Bradley, director of a shelter and soup kitchen in rural Ukiah, California, chooses to live on less than a taxable level of income annually. He was hit with the $500 penalty because he used a blank IRS Form 1040, containing his name and Social Security number, on April 15, 1984, to express his conscientious objection. Across the form he wrote: "In watching the U.S. government's intervention in Central America and the deployment of homicidal nuclear weapons, I can no longer be complicit in paying taxes. My allegiance is to the law of a higher spirit, the law of God." Two months later, the IRS sent him a blank tax return with advice as to the requirements for filing, telling him only that the previous form was "unacceptable." Since, as correctly stated in the instructions accompanying the blank forms, he had no obligation to file at his income level, he did nothing. Then the penalty was assessed. Applying a literal interpretation of § 6702, a federal appellate court actually upheld this assessment, ruling that the protest "return" did not contain sufficient information to determine whether the _implied_ "self-assessment" of zero (because the return contained no figures) was correct (which it was). 817 F.2d 1400 (9th Cir. 1987). Again, this example is not extraordinary as to the kinds of people and the kinds of circumstances under which an unreformed "frivolous return" penalty has been and will be asserted.

Under the plain language of the Code, it was (and is) not clear whether the requirement under § 6702(a)(1) that the self-assessment not be "substantially" affected implies that some degree of discrepancy may be disregarded,[2] and thus implies a requirement that IRS establish what the "correct" assessment would have been. Nor was (or is) it clear what "self-assessment" means. See _Atlantic Mutual Ins. Co. v. McMahon_, 153 F.Supp. 48, 51 (S.D.N.Y. 1957) ("Self-assessment is not a technical term of tax law, but merely ... colloquial in nature."); accord, _Farnsworth & Chambers Co. v. Phinney_, 178 F.Supp. 300, 333 (S.D.Tex. 1959), _aff'd_, 279 F.2d 538 (5th Cir. 1960). The most reasonable assumption would be that the term refers to the individual filer's statement of the total amount of tax that would be due for the year, _cf._ 26 U.S.C. § 6201(a) (assessment by Secretary), yet the leading case says it also includes "representations on the return as to the ... refund claimed." _Franklet v. United States_, 578 F.Supp. 1552, 1555 (N.D.Cal. 1984), _aff'd_, 761 F.2d 529 (9th Cir. 1985); accord, _Kahn v. United States_, 753 F.2d 1208 (3d Cir. 1985) (penalty upheld as applied to refund claim, although tax due was properly calculated).

Likewise, the statutory term "frivolous" -- undefined in the statute -- has been interpreted by the courts as if it meant "unsupported by the Internal Revenue Code and established precedent construing it," while in general legal circles it means a contention which is not "well grounded in fact and ... warranted by existing law _or a good faith argument for the extension, modification, or reversal of existing law_." Fed.R.Civ.P. 11. Yet many have been penalized under § 6702 who have good faith arguments to make for the extension or reversal of existing constitutional law, often in jurisdictions which have never addressed these arguments.[3] And finally, the key term "position" in §

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[2] _Cf._ 26 U.S.C. § 6661 ("substantial" understatement penalty, enacted in same legislation, establishing $5000 disregard).

[3] The tax C.O.'s constitutional claim is not settled in the Supreme Court nor in most Circuits, and is not one that we would concede. A reasonable lawyer's argument can be made that the Free Exercise Clause requires the government to accommodate the conscientious objector who is willing to pay the full amount of taxes, if only the money paid will be sequestered in a fund not available for military spending, akin to the Presidential Campaign Fund, 26 U.S.C. §§ 6096, 9006(a); the Crime Victims Fund, 42 U.S.C. § 10601; or the Highway Trust Fund. _Cf._ 26 U.S.C. § 1402(e)(1), (g) (accommodating conscientious objectors to Social Security). _See_ Comment, _War Tax Refusal Under the Free_

6702(a)(2)(A) has also been interpreted as if it meant something different from what it means in tax practice generally; that is, a taxpayer whose return irregularity is expressly predicated solely on a religious "position" and not on any position with respect to a point of tax law may be penalized anyway. Compare Rowen, When May a Lawyer Advise a Client that He May Take a Position on His Tax Return?, 29 [ABA] Tax Lawyer 237 (1976); ABA Stand. Comm. on Ethics & Prof. Resp., "Tax Return Advice," Formal Op. 85-352 (July 7, 1985). See Jenney v. United States, 755 F.2d 1384 (9th Cir. 1985), rev'g, 581 F.Supp. 1309 (C.D.Cal. 1984) (lower court had held "self-assessment" not incorrect where attached letter contained correct liability figure and fully explained claim of "war tax deduction").

As a result of these vague statutory terms and the courts' excessively lenient construction of them (contrary to the Supreme Court's mandate of strict construction of penalty language, see Commissioner v. Acker, 361 U.S. 87, 91 (1959), on which Congress no doubt relied in the initial drafting), hundreds of well-meaning and entirely sincere conscientious objectors, who harbored no desire to obstruct or impede the IRS, found themselves penalized under § 6702 between 1983 and 1985. Most had no idea this penalty existed at the time they chose to express their objections on their returns. Since the religious conscience seldom dictates the employment of any particular "tactic" to satisfy the demand to act in accordance with belief, most objectors have since been "deterred" from indicating their objection on the return in such a way as to incur this penalty. As a result, only the uninformed or badly advised are likely now to be subjected to it. As to them, however, the IRS continues to impose the penalty just as it did in the early years -- without warning, virtually without explanation, and (except where the illegitimate deduction or credit claimed is less than $500, see Int. Rev. Manual 4293.7 (eff. 6/11/85)) without opportunity to file an amended return rectifying the situation.

Contrary to what the IRS has argued repeatedly in court (and which some careless judges have seemed to accept), the applicability of § 6702 to a return does not depend solely on whether the income tax law makes allowances for conscientious objectors. The penalty statute is complex and has numerous elements. In addition, procedural regularity is often contested. The notice form used by IRS to announce the assessment of the frivolous return penalty does nothing to inform the recipient of what year's return is being penalized, what combination of "prongs" of the statutory penalty is thought to apply, or what about the return in question subjected it to penalty under the statute. There is thus no way for the individual to know if s/he has been penalized in error. Nor is such information forthcoming in the

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Exercise Clause, 1980 Wisc.L.Rev. 753 (demonstrating that contrary cases rely on authority applying a now-abandoned First Amendment test). Such an argument would make an analogy to the First Amendment doctrine of Abood v. Detroit Bd. of Educ., 431 U.S. 209 (1976) (right to refuse portion of compulsory union dues to be spent on political purposes with which individual disagrees).

The dictum in United States v. Lee, 455 U.S. 252, 260 (1982), which relies on those same unsound precedents, disavows only a claimed right not to pay at all. The ratio decidendi of Lee itself, on the other hand, affirms the Free Exercise test under which the government bears the burden of proving accommodation is not possible. See also Lyng v. Northwest Indian Cemetery Protective Ass'n, 485 U.S. --, 99 L.Ed.2d 534, 547 (1988) (Free Exercise problem exists where government program would "coerce individuals into acting contrary to their religious beliefs").

administrative review process, which generates boilerplate denials of appeals.

These problems in administration have met with continuing judicial criticism. See *Bothke v. United States*, 670 F.Supp. 285 (C.D.Cal. 1987) (refund ordered); *Harper v. United States*, 587 F.Supp. 1056, 1059 n.2 (E.D.Pa. 1984), *aff'd mem.*, 760 F.2d 257 (3d Cir. 1985). Thus, many of the return-filers who had been subjected to the penalty, as well as the lawyers to whom they turned, reasonably believe that the penalty is applied arbitrarily and improperly, if not without due process in the most fundamental sense of notice.[4]

In addition, the stated purpose of the frivolous return penalty was to deter "tax protesters" from filing useless returns and to compensate IRS for its trouble in processing them, where there was no underpayment as required for the assessment of a "negligence" penalty, *see* Code § 6651(b) [discussed in Point 4 below], or at least none sufficient for 5% of it to be an adequate penalty. Yet under § 6702(b), the frivolous return penalty can be (and is) levied in addition to any other penalty. As a result, where there is a deficiency on the return, there is in effect a 5%-of-understatement surcharge on the frivolous return penalty, contrary to any legitimate purpose of the statute.

The principal additional aspect of this penalty is its focus on the filer's expressed purpose; the "conduct" has to be "due to" adherence either to a "position which is frivolous" or to an explicit "desire" to impede. And IRS is of the view that the filer's "position," to come within the statute, need not be a theory about tax law, but may be simply the filer's "position" on political, moral and religious issues, even if the filer does not contend that these legally justify his or her manner of completing the return. Thus, the frivolous return penalty, either on its face or as applied, tends to penalize the exercise of mere speech as well as the right to petition for a redress of grievances. For all of these reasons, substantial reform of the § 6702 "frivolous return" penalty is warranted.

Conclusion and Recommendations: Although the frivolous return penalty, as drafted and applied, fails almost all of the ABA Task Force's excellent criteria for an appropriate penalty -- clarity of terms, proportionality, non-redundancy -- the Task Force report recommends that it not only be retained, but actually that it be doubled in amount. The only reason offered seems to be that it has been an effective deterrent, but is expensive to administer because of frequent court challenges. The first rationale is illogical in and of itself, since only if the penalty had been *ineffective* at its present level would it need to be enhanced. And the high cost of imposition, as described by the Task Force, results as much as anything from the IRS's failure to administer it fairly or to explain its assessment to those affected.

Congress should reform the frivolous return penalty provision significantly.

- The terms highlighted above should be given statutory definitions consistent with the broader body of law.

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[4] Concomitantly, since the statute explicitly places the burden of proof upon the IRS, 26 U.S.C. § 6703(c), the enforcement scheme seems to encourage persons having any doubt as to the appropriateness of the penalty in their cases to sue and put the government to its proof. Yet if they do, they may find themselves penalized by the court. See *Dalton v. United States*, 800 F.2d 1316 (4th Cir. 1986), *cert. denied*, 107 S.Ct. 1911 (1987) (White, J., dissenting). See Point 2 of this Statement, below.

- Section 6213(g)(2) of the Code (correction of mathematical or clerical errors without resort to deficiency procedures) should be amended to apply where the "self-assessment" can be seen on the face of the return to be incorrect, and the correct tax figure (or sufficient information to calculate it) is given on the return or in an attachment; in this situation, the frivolous return penalty should not apply.
- Nor should this penalty be imposable in addition to a "negligence" penalty for disregard of rules in any case.
- The penalty should not be assessed without clear notification of the basis for its proposed imposition and a request for an amended return first being sent, and then not unless there is an understatement at least as large as the penalty.

We stand ready to lend our resources to aid the subcommittee in this drafting effort.

2. Frivolous Tax Court Litigation - Code § 6673.

Internal Revenue Code § 6673, as amended by TEFRA (1982), provides for an award of "damages" of up to $5000 to be assessed by a Judge of the Tax Court, in the court's discretion, against a petitioner who initiates or maintains a proceeding in that court primarily for the purpose of delay or whose position is "frivolous or groundless." (Until 1982, the maximum amount had been $500 and the only ground was "instituted for delay.") For the same reasons mentioned under Point 1 above, only an ignorant or ill-advised conscientious objector would attempt to argue in the Tax Court in favor of either an exemption from filing or paying, or for a right to insist upon governmental sequestration of their funds in an account not available for military spending. Nevertheless, from time to time, sincere religious objectors who have not consulted competent counsel do find themselves before the Court, having followed the instructions in a Notice of Deficiency that this is the way to pursue their appeal from an assessment they find intolerable to their conscience. It is our experience that in such cases, the § 6673 penalty is imposed so arbitrarily as to call for Congressional reform.

Irv and Jenny Hollingshead are active Quakers from Lancaster County, Pennsylvania. Their stand has been, on religious grounds, that they wish to pay their full share of taxes but cannot do so if the military portion is put to uses that are inconsistent with the demands of conscience. Without counsel, they appealed deficiencies for 1980 and 1981 to the Tax Court. After being informed of and threatened with the § 6673 penalty they took all available procedural steps to expedite their case, and presented an argument to the Court based on recent U.S. Supreme Court Free Exercise Clause cases which the Tax Court had never discussed in an opinion. Nevertheless, the judge not only rejected their claim but also imposed "damages" of $250 for their pre-1982 filing and $750 for the later petition. The only reason was an unexplained "conclu[sion] that the proceedings were instituted for delay." T.C. Memo 1984-158. When the Hollingsheads then filed affidavits contradicting this assertion, the court, again without explanation, reduced the "damage" assessments to $150 in each case.

On the other hand, equally arbitrarily, the Tax Court has declined to employ § 6673 in cases indistinguishable from the Hollingsheads'. Vinton Deming of Philadelphia, editor of the Friends Journal, a religious periodical, and Phyllis Babcock, a Quaker school teacher, advanced exactly the same contentions as the Hollingsheads before the Tax Court in 1986, in consolidated cases that had been filed in 1985 and 1983 respectively. A different Tax Court judge also rejected the constitutional argument, but then refused the Commissioner's claim for "damages" under § 6673, "[u]pon due consideration" but without explanation. T.C. Memos 1986-168 and 1986-169.

The federal courts of appeals, which are charged with reviewing Tax Court decisions, have criticized the arbitrariness of these assessments, even while holding that the statutory term "damages" (rather than "penalty") does not imply a requirement that a measure of actual excess cost be proven by the IRS. See Sauers v. CIR, 771 F.2d 64 (3d Cir. 1985); May v. CIR, 752 F.2d 1301 (8th Cir. 1985) (requiring statement of reasons).

Conclusion and Recommendations: Language should be added to § 6673 to provide that damages may be assessed only upon a finding of "bad faith," in the sense of a subjective desire to abuse the litigation process rather than to petition the court for a redress of grievances, as protected by the statute establishing the Tax Court and by the First Amendment. Where the penalty is to be asserted on the basis of the taxpayer's legal argument, prior knowledge of controlling adverse precedent should be required, but not sufficient; there should also have to be an absence of a good faith argument for the extension, modification or reversal of existing law. Cf. Fed.R.Civ.P. 11. The penalty should never be applied except after notice and hearing, at which the IRS should have the burden of proving a specific amount of excess cost and that it made every effort to minimize those costs. Finally, the Tax Court should be required to provide a statement of reasons for imposing the penalty and for its selection of the amount.

On a related subject, we oppose the ABA Task Force's suggestion that penalties imposed by courts under Fed.R.Civ.P. 11 and Fed.R.App.P. 38 in tax related cases be made collectible by the IRS as taxes. This unprecedented proposal is unsupported by experience and contrary to all existing law concerning collection of judgments and court costs.

3. False Withholding Certificate - Code § 6682.

The 1981 tax legislation added a flat $500 civil penalty for the filing of an employee withholding certificate, Form W-4, which contains a statement which results in a decrease in withholding and for which "there was no reasonable basis." Code § 6682. The Internal Revenue Manual advises agents conducting civil investigations of persons labelled as "tax protesters," a category in which the IRS erroneously includes conscientious military tax objectors, to look into any W-4 for a possible violation of this provision. Overzealous enforcement is a predictable result, which in turn can lead and has led to erroneous application of this penalty. Congress can protect against this by requiring that the IRS follow rudimentary fairness in applying the false W-4 penalty.

For example, in Philadelphia in 1982 a Quaker public school teacher, Ruth Kirk, was assessed various penalties after filing tax returns claiming a "war tax deduction." One was a $500 penalty the basis of which was never stated to her in the notices she received. Her letters seeking an explanation were either ignored or received contradictory answers informing her variously that the penalty was for filing a false W-4 (which she had not done) or for filing a frivolous return (which provision was not effective until 1983). Congressional inquiries met with the same frustrating response. This sum, along with other alleged deficiencies and penalties (much of which was also totally baseless) was eventually seized by levy from her salary. Just before the statute of limitations for seeking a refund had run, Mrs. Kirk sought legal advice. The Service Center eventually was able to inform counsel that the penalty was indeed for a "false W-4" and was based on the School District's informal response to an inquiry. The investigating agent had never even looked at the actual W-4, and when counsel retrieved it from the employer's files, the form in question was entirely proper and free of any false statement. Nearly five years after imposition of the penalty, a refund (including interest) was awarded.

Conclusion and Recommendations: Congress should require that IRS issue a clear notice whenever the false W-4 penalty is imposed, including a statement of the specific factual basis (date of form and content of alleged false statement). This notice should contain advice of the procedure for appealing an erroneous imposition of this penalty (a request for abatement addressed to the "W-4 Coordinator" at the Service Center), which is currently nowhere explained. Abatement of the penalty should be mandatory for a first offense where the taxpayer agrees promptly to file a correct form. Finally, to avoid duplication, this penalty should not be imposable in addition to the penalty under § 6651 for nonpayment, where the underpayment results from underwithholding caused by the baseless W-4.

In addition, we urge that Congress allow an exemption from the withholding system for those whose religious consciences preclude voluntary payment of taxes for military purposes, at least where the individual files a correct return and submits to involuntary collection by levy of the full amount of tax, plus the simple interest penalty as calculated in Code § 6654. See American Friends Service Comm. v. United States, 368 F.Supp. 1176 (E.D.Pa. 1973), rev'd on proc. grnds., 419 U.S. 7 (1974) (per curiam).

4. "Negligence" and Fraud - Code § 6653.

The Internal Revenue Code currently provides a penalty of 5% of the total understatement if any part of it is due to disregard of IRS rules. (Although commonly called the "negligence" penalty, negligence in the ordinary legal sense is not required.) The penalty for fraud was altered in the 1986 Code to provide for a 75% surcharge on the amount of understatement due to fraud. In each case there is also an interest surcharge. Code § 6653.

The IRS tends to disregard the profound differences of philosophy, motivation, goals and tactics between military tax objectors, on the one hand, and anti-tax "protesters," on the other. See generally GAO, "Illegal Tax Protesters Threaten Tax System" (GGD-81-83, July 8, 1981). As a result, conscientious objectors are sometimes targeted for overzealous enforcement. For example, the Tax Court has long held that the onerous civil fraud penalty does not apply to a forthright, although legally invalid, claim of a "war tax credit." Muste v. Commissioner, 35 Tax Ct. 913 (1961). Yet IRS continues to assert such penalties form time to time, and individuals must appeal. E.g., Regan v. Commissioner, 86-1 U.S.T.C. ¶7381(M) (1986). Others, less determined to assert their rights, no doubt succumb. And in some Circuits, it is not even clear that such forthright conduct is protected. Compare Raley v. Commissioner, 676 F.2d 980 (3d Cir. 1980), with Granado v. Commissioner, 792 F.2d 91 (7th Cir. 1986) (per curiam) (civil fraud penalty can apply even where there has been full disclosure).

Conclusion and Recommendations: The ABA Task Force recommends differentiating between negligent and intentional disregard, and increasing the penalty to 25% in the former case, 50% in the latter, of the affected portion of the tax. The 25% rate is far too high for nonfraudulent conduct, especially where there is no indication of bad faith. Indeed, the Tax Force cites no evidence that the 5% rate is insufficient. In any event, mere ignorance or misunderstanding of tax law is the norm for ordinary people, and should not be penalizable as negligence at all. We agree that these penalties should be tied to the affected portion of the understatement, rather than the whole amount, and that it is not unreasonable to differentiate nonfraudulent but intentional disregard from negligence. The higher rate might perhaps be 10%, but even this should not apply where the only disregard is of the obligation to pay, nor where there is full disclosure of relevant facts on the return or an attached explanation. Nor should a §6653 penalty be in addition to any other penalty for the same conduct, such as non-payment under §6651, frivolous return (§6702) or false W-4 resulting in underwithholding (§6683).

The ABA Task Force would abolish the substantial understatement penalty (Code §6661), but we think this provision is exemplary in its provision encouraging disclosure of relevant facts or law where a dubious claim of such magnitude is made. As a matter of religious and ethical principle, conscientious military tax objectors almost always make such disclosures, regardless of the amount in issue. Section 6653 should provide that such disclosure, in and of itself, bars imposition of a disregard penalty (without §6661's requirement of "substantial authority").

Likewise, to resolve the split in the Circuit Courts, §6653(b) should endorse the Tax Court's Muste rule and specify that a fraud penalty does not apply to conduct which has been fully disclosed and explained on the return or in an attached or referenced statement.

5. Delinquency Penalties - Code Section 6651.

We urge that if the "negligence" penalty is raised above the current 5% level, then it should not be imposable in addition to the late payment or failure to pay penalty (§6651 (a)(2)), to eliminate redundancy or "pyramiding."

6. Refusal to Honor a Levy - Code Section 6332 (c) (2).

Code §6332(c)(2) provides for a 50% penalty for any person who, without reasonable cause, refuses to honor an IRS levy. This applies, for example, to an employer on whom a levy is served demanding the surrender of wages owing to an employee wo is subject to a lien for unpaid taxes. this penalty is not assessable as a tax; enforcement is by civil suit in the U.S. District Court. An officer or employee of the levied entity is also personally liable for this penalty if, by virtue of his or her office, s/he has the duty to surrender the property sought by the levy. Code §6332(e). IRS enforcement of this penalty has also been arbitrary, and has failed to show deference or respect for the impingement of religious conscience that may be involved in these cases.

For example, the Philadelphia Yearly Meeting of the Religious Society of Friends has on occasion declined to honor levies to collect the taxes of its objecting employees, on the related Quaker principles of respect for individual conscience and the church's 300-year history of adherence to a "Peace Testimony." In a 1984 lawsuit to enforce a levy against Philadelphia Yearly Meeting, the government chose to sue an individual employee as a co-defendant, but not to seek the 50% penalty. (PYM did not resist the lawsuit and made known to the Tax Division the location of an account containing sufficient funds to satisfy the judgment.) Especially peculiar was a 1985 lawsuit against the Con$cience & Military Tax Campaign (a secular activist organization that maintains an escrow account for conscientious military tax objectors): when CMTC was served with a levy (not for an employee's taxes, but for a depositor in its escrow account), the organization succeeded in persuading the depositor to satisfy the tax claim himself, but CMTC still wound up being sued successfully for the 50% penalty (although not for the principal amount).

Conclusion and Recommendations: The 50% penalty under §6332 (c)(2) should be clarified to specify that it is not unreasonable for the recipient of a levy to delay compliance long enough to investigate whether the property sought is "subject to levy," (§6332(c)(1)), that is, to inquire into the substantive or procedural validity of the levy (for example, whether the notice required under §6331(d) has been given), or to attempt (for a period not exceeding 21 days) to have the taxpayer satisfy the lien directly. Second, there should be no personal liability under § 6332 (c)(2), (e) for the entity's refusal of a levy unless that individual has authority to cause payment without violating the rules governing his or her employment.

Third, this penalty is disproportionately high in comparison with others. A 10% rate would be more consistent with equivalent penalties which apply where a third party fails in a duty to pay and there is no difficulty in detection; see, e.g., Code §6656(a) (failure to withhold and pay over).

Finally, this penalty provision should specify that it is not "unreasonable" for the recipient of a levy to refuse to honor it in accordance with a sincerely held religious principle against coercing the conscience of its creditor (e.g. employee or depositor), unless the IRS can prove that no reasonable alternative enforcement or collection device is available.

Conclusion

Since 1972, efforts have been underway in Congress to establish a right of conscientious objection for taxpayers who, on religious grounds, cannot participate in the funding of warmaking, war preparation, or other military activity. Under this proposed legislation, the objectors would pay the full amount of taxes owed, but the law would provide a mechanism to assure that their contributions would not be spent in violation of their fundamental beliefs. Such an approach would be analogous to the Conscientious Objector provisions of the Selective Service law and no more problematic than existing accomodations of clergy and Amish objections to the Social Security system found in sections 1402(e)(1) and (g) of the Internal Revenue Code. It would not be significantly more difficult to administer than the existing Presidential Campaign Fund check-off. Now known as the U.S. Peace Tax Fund Act, this legislation was substantially revised and reintroduced in 1985 in its current form. In the 100th Congress, it is known in the House as H.R. 2041 and in the Senate as S. 1018. A copy is attached. Bi-partisan co-sponsorship currently stands at 49 representatives and three senators. While this legislation, if enacted, might not satisfy every person on either side of the question, it is apparent from this example that a solution to the dilemma is possible and from the perspectives of both the affected individuals and the over-burdened IRS, desireable.

Pending that day, however, military tax objectors will not be able to ignore their consciences. As a result, they will continue to be subjected to various Internal Revenue Code penalties. The reforms suggested above would go a long way to alleviating the unfairness and unnecessary harshness that now exists in the civil tax penalty system for many of these sincere and faithful people.

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